

THE DEATH OF BIG LAW

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University of Illinois, Draft of January 4, 2010*

Abstract

Large law firms face unprecedented stress. Many have dissolved, gone bankrupt or significantly downsized in recent years. This article shows that the downsizing of Big Law reflects a basically precarious business model rather than just a shrinking economy. Because large law firms do not own durable, firm-specific property, a set of strict conditions must exist to bind the firm together. Several pressures have pushed the unraveling of these conditions, including increased global competition and the rise of in-house counsel. The business model of the large law firm therefore requires fundamental restructuring. The paper discusses new business models that might replace Big Law, how these new models might push through regulatory barriers, and the broader implications of Big Law's demise for legal education, the creation of law and lawyers' role in society.

* Thanks to Dan Rock for helpful research, and to helpful comments by Kenneth Adams, Amitai Aviram, Michael Bell (Frontierion, LLC), Mark Galanter, William Henderson, Erik Gerding, Houman Shadab, Marc Taylor (Taylor English Duma), and participants at the Conference on the Future of the Global Law Firm, Georgetown Law Center, April 17, 2008 and The Future is Here: Globalization and Regulation of the Legal Profession, May 27, 2009, Midwest Law & Economics Association, 2009 Annual Meeting, and workshops at the University of Wisconsin and University of Illinois law schools.

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Few industries have suffered more visibly from the financial meltdown of 2008-2009 than the nation’s largest law firms (what this article refers to as “Big Law”). After a half century of rapid growth, many large and established firms have dissolved or gone bankrupt since 2000,¹ and others have significantly downsized. According to an annual survey concluded at the end of September, 2009, the top 250 law firms lost 5,259, or 4%, of their lawyers, including 8.7% of their associates; 15 of the top 75 law firms dropped more than 100 lawyers each.² It was by far the worst decline in the thirty years of the survey. Law firms disclosed that they laid off more than 14,000 people in 2008 and 2009.³ Another survey at the end of 2009 found that forty percent of big law firms had

¹ See *infra* subpart I.E.1 (discussing some prominent examples).

² See Leigh Jones, *2009 Worst Year for Lawyer Headcount in 3 Decades, Says 'NLJ 250' Survey*, Nat’l Law Journal (November 9, 2009), available at <http://www.law.com/jsp/law/LawArticleFriendly.jsp?id=1202435276422/>.

³ See Lawshucks.com’s Layoff Tracker, <http://lawshucks.com/layoff-tracker/>, showing a total of 14,094 in 2008-2009 as of November 15, 2009, with (5,511 lawyers and 8,583 staff), with 12,102 (4,581 lawyers and 7,521staff) in 2009. These numbers understated the problem taking into account the total personnel loss reflected in the National Law Journal data. See Lawshucks.com, November 10, 2009,

reduced associate starting pay, 44 percent were considering doing so in 2010, while sixty percent of the firms had deferred associate start dates in 2009, and 43 percent expected to do so in 2010.

Big Law's basic problem is not the general economy or a decline in the overall demand for legal services. Indeed, the long term problems with Big Law may have been masked until recently by a strong economy, particularly in finance and real estate. Rather, the real problem with Big Law is the non-viability of its particular model of delivering legal services. As I discussed in a previous article,⁴ Big Law's main function is to bond lawyers' promises of faithful performance. To do this, law firms have to establish incentive and compensation devices that encourage members to invest in developing the firm's reputation rather than solely their own books of business. However, professional ethics rules, particularly including rules restricting limited liability, non-lawyer ownership and non-competition agreements, impede the growth of large law firms.

The present article expands on and updates this initial work by showing how additional stresses, including better informed clients and intensified competition in the global market for legal services, now threaten Big Law's already precarious equilibrium. Big Law's problems now extend beyond unaccommodating professional rules and can be solved only by adopting significantly different business models that involve ownership of firm specific property and that can attract outside financing. Indeed, even these changes may not be enough. In the future, the sale of legal expertise may move beyond law firms to include direct applications in finance and product development.

Part I of this article examines Big Law's inherent structural flaws and the forces that are destabilizing it. Part II discusses new approaches to delivering legal services that are likely to replace the existing model. In general, these firms will own intellectual and other property and produce products rather than focusing on rendering individualized advice to clients. Part III discusses the changes in the framework for regulating large firms that are necessary to facilitate these new modes of delivering legal services, and how these changes might come about through competition, contracts and financial innovation. Part IV concludes by discussing some broader implications of these important changes in the practice of law for legal education and the legal system.

I. THE BREAKDOWN OF THE TRADITIONAL MODEL

Law partners are both employees who earn money from their human capital and co-owners of the firm. It may be unclear what value is produced by the firm as distinguished from the individual lawyers. In other words, what is the source of the earnings received by the firm as an entity and distributed to the lawyers as owners? This Part begins by summarizing the standard economic model of the law firm and the

<http://lawshucks.com/2009/11/nlj-numbers-indicate-abundant-stealth-layoffs/> (noting that NLJ shows that there were 5,259 fewer lawyers in the top 250 compared with the previous year, and that some firms had shed more lawyers than they reported in layoffs).

⁴ See Larry E. Ribstein, *Ethical Rules, Agency Costs and Law Firm Structure*, 84 VA. L. REV. 1707 (1998).

implications of this model for the structure and governance of large firms. It then discusses how this model is breaking down from its inherent weakness and the additional stresses imposed by the current economic environment of law practice.

A. THE BASIC REPUTATIONAL BONDING MODEL

Large law firms' value derives from their function of ameliorating the inherent asymmetry of information between lawyers and clients. It is hard for clients to shop for the most skilled and trustworthy lawyer because as non-experts they may not be able to accurately judge the quality of the lawyer's services even long after they are rendered. This makes legal services a "credence" good that requires special reliance by the customer on the seller.⁵

This information asymmetry may exacerbate agency costs between lawyers and clients. These costs arise because clients typically delegate power to the lawyer over some portion of their affairs, and lawyers' and clients' interests differ.⁶ For example, lawyers may shirk because they do not get all the gain from more careful work, or may spend too much time because they are compensated according to time spent rather than amount accomplished.⁷ It may be impossible for clients to determine in advance which lawyers present the highest risks.

Law firms can help clients by monitoring and screening potentially untrustworthy lawyers. The law firm's long-lived reputation for honest and faithful service can bond its promise to monitor and screen.⁸ Clients are willing to pay extra to buy legal services from a big firm because they know that a cheating firm incurs a penalty in the form of a diminished reputation and a lower price for its services. The reputational bonds posted by individual lawyers may have less value than those of firms because young lawyers have not yet developed a reputation and lawyers nearing retirement have little future income left to forfeit as a penalty for breach of trust. A law firm in effect "rents" its reputation to

⁵ See Michael R. Darby & Edi Karni, *Free Competition and the Optimal Amount of Fraud*, 16 J. L. & ECON. 67, 68-69 (1973) (discussing the general nature of credence goods); Ellen R. Jordan & Paul H. Rubin, *An Economic Analysis of the Law of False Advertising*, 8 J. LEG. STUD. 527, 530-31 (1979) (describing credence qualities as requiring the non-expert to rely on the seller). By contrast, consumers can evaluate "search goods" before use, and "experience goods" after repeated uses. See Philip Nelson, *Information and Consumer Behavior*, 78 J. POL. ECON. 311 (1970).

⁶ See generally, Jonathan R. Macey & Geoffrey P. Miller, *An Economic Analysis of Conflict of Interest Regulation*, 82 IOWA L. REV. 965 (1997); Ribstein, *supra* note 4.

⁷ See Donald C. Langevoort & Robert K. Rasmussen, *Skewing The Results: The Role of Lawyers in Transmitting Legal Rules*, 5 S. CAL. INTERDISC. L.J. 375 (1997) (lawyers may inflate work by overstating legal risks); Richard H. Sander & E. Douglass Williams, *Why Are There So Many Lawyers? Perspectives on a Turbulent Market*, 14 J.L. & Soc. Inquiry 431 (1989) (noting that more lawyers can result in greater aggregate demand for legal work because lawyers can create work for themselves).

⁸ See Benjamin Klein & Keith B. Leffler, *The Role of Market Forces in Assuring Contractual Performance*, 89 J. POL. ECON. 615 (1981). For criticism of reputational bonding as applied to law firms, see Ted Schneyer, *Reputational Bonding, Ethics Rules, and Law Firm Structure: The Economist as Storyteller*, 84 VA. L. REV. 1777 (1998) (questioning whether the corporate clients of large law firms really rely on these firms' reputations).

its lawyers just as a roadside franchise restaurant uses the franchisor's reputation to draw customers.

B. LAW FIRM STRUCTURE

In order for large law firms to perform their reputational bonding function they must motivate their lawyers to provide the mentoring, screening and monitoring that supports the firm's reputation. The problem is that lawyers constantly must allocate time and effort between building the firm's reputation and building their own clientele. If the ties binding lawyers to firms unravel, lawyers' temptation to build their personal human capital and client relationships may trump their incentive to invest in building the firm. The firm may then become just a collection of individuals sharing expenses and revenues that has little or no value as a distinct entity. The following subsections discuss the elements of law firm governance necessary to provide the right incentive.

1. Law firms as partnerships

The standard corporate hierarchical structure in which passive owners delegate management functions to expert managers may not work for professional firms. Alchian & Demsetz argue that law and other professional firms must be partnerships because non-expert owners and managers cannot adequately monitor professionals.⁹ However, as law firms grow, even expert monitoring is stretched thin. This puts the emphasis on aligning incentives through pay, promotion and liability. As discussed in the following subsections, these devices are subject to their own strains in large law firms.

2. Compensation

Lawyer-owners of a law firm need to be rewarded for the firm's overall success to motivate them to contribute to this success by monitoring the other worker-owners. Lawyers who are paid solely based on their individual books of business obviously will focus on their personal clients and neglect building general firm business. This incentive is reinforced by the fact that the lawyer's book of business may determine her market value outside the firm and therefore her mobility.

The most direct way to compensate lawyers based on the firm's success is simply to give them shares of the firm's profits that are adjusted only to reflect lawyers' seniority and not their individual rainmaking or billing contributions.¹⁰ Seniority-based sharing motivates lawyers not only to maintain the firm's reputation, but also to admit only the highest quality partners.¹¹ Under equal or seniority-based compensation, admitting a new partner necessarily reduces incumbent partners' income unless the new partner brings in

⁹ See Armen A. Alchian and Harold Demsetz, *Production, Information Costs and Economic Organization*, 62 AM. ECON. REV. 777 (1972).

¹⁰ See Ronald J. Gilson & Robert Mnookin, *Sharing Among the Human Capitalists: An Economic Inquiry into the Law Firm and How Partners Split Profits*, 37 STAN. L. REV. 313 (1985) (discussing seniority-based compensation as a way to diversify away risks affecting the value of partners' individual human capital).

¹¹ See Jonathan D. Levin & Steven Tadelis, *A Theory of Partnerships* (October 2002), Stanford Law and Economics Olin Working Paper No. 244, available at <http://ssrn.com/abstract=311159>

enough additional net income to offset the additional share. Firms that depart from equal or seniority-based sharing may be tempted to admit low-quality professionals and try to get away with charging clients more for these lawyers' time than they are worth. If the market accurately values the lawyer's services, the firm can adjust the lawyer's compensation accordingly.

Seniority-based compensation also can enable lawyers to invest their human capital in a diversified portfolio of careers and thereby to minimize the risks inherent in shifts in the economy.¹² This compensation method keeps the income flowing to all lawyers in good times and bad. Reducing risk can enable diversified firms to hire talent at a lower price than less diversified rivals.

Seniority-based compensation is vulnerable to lawyers' temptation to free-ride on their colleagues' monitoring and screening efforts and focus on maintaining their own books of business.¹³ The firm may have to rely more on other monitoring and incentive devices than on compensation.¹⁴ It also may have to depart from equal or seniority based compensation to keep rainmakers, and give up on human capital diversification and pay lawyers who happen to be in "hot" areas more to retain them.

3. Promotion

Law firms provide incentives not only through compensation but also in how they choose partners. They ensure their lawyers' quality by putting associates through a winnowing process at the end of which they are either promoted to partner or asked to leave.¹⁵ The tournament helps instill firm culture in associates¹⁶ and ensure that only the highest quality lawyers become owners. This reinforces equal or seniority-based compensation by increasing the likelihood that lawyers will contribute to building the firm. The tournament is an important aspect of the so-called "Cravath system" for maintaining careful selection and training of associates and maintenance of a strong firm culture.¹⁷

¹² See Gilson & Mnookin, *supra* note 10.

¹³ See *id.* at 374.

¹⁴ See Roger Bowles & Goran Skogh, *Reputation, Monitoring and the Organisation of the Law Firm*, in *Essays in Law and Economics: Corporations, Accident Prevention and Compensation for Losses* 33, 33-47 (Michael Faure & Roger Van den Bergh eds., 1989) (discussing tradeoffs between dismissal, profit-sharing and monitoring).

¹⁵ See Marc Galanter & Thomas Palay, *TOURNAMENT OF LAWYERS: THE TRANSFORMATION OF THE BIG LAW FIRM* (1991). The "out" part of this "up-or-out tournament" has been explained as binding the firm not to cheat on its implicit promise by trying to keep successful associates without making them partners. See Ronald J. Gilson & Robert H. Mnookin, *Coming of Age in a Corporate Law Firm: The Economics of Associate Career Patterns*, 41 *STAN. L. REV.* 567 (1989).

¹⁶ With respect to the importance of firm culture, see Ronald J. Daniels, *The Law Firm as an Efficient Community*, 37 *McGill L.J.* 801, 822-25 (1992).

¹⁷ See William D. Henderson & Leonard Bierman, *An Empirical Analysis of Lateral Lawyer Trends from 2000 to 2007: The Emerging Equilibrium for Corporate Law Firms* (May 19, 2009), Indiana Legal Studies Research Paper No. 136 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1407051;

Even a well-executed tournament system may be unstable. The Cravath system was established in a less competitive law firm environment than prevails today. Once a Cravath-type firm has to start generating higher profits in order to retain its stars, it may have to resort to lateral hiring and increasing the ratio of associates to partners. The firm then might have trouble committing to seniority-based compensation and to the up-or-out tournament.

4. Vicarious liability

Law partners' joint and several liability for the law firm's debts helps ensure that partners will support the firm's reputation by carefully selecting and monitoring colleagues who might create liabilities. Vicarious liability therefore tends to reinforce the equal sharing compensation model. It also helps keep firms intact because lawyers who leave remain responsible for liabilities incurred during their tenure. As discussed below, however, vicarious liability is a casualty of the evolution of law firms, which poses another challenge to the reputational capital model.

C. CLIENT DEMAND FOR BIG LAW

Ronald Gilson at least partially explains the demand for Big Law in terms of information asymmetry between lawyers and clients.¹⁸ This is consistent with the reputational bonding theory of the law firm discussed in subpart A. Clients have problems judging the value of expert services. The client therefore relies on a "rainmaking" partner with whom the client may have a long term relationship to recommend one or more specialists who will perform the particular services the client demands. The law firm's reputation helps bond the specialist's implicit promise that the referral is motivated by the client's best interests rather than the expectation of a kickback from the specialist.¹⁹

This information-based theory of Big Law helps explain large law firms' durability. Since the client's ability to rely on the rainmaker is based on a long-standing relationship, the client could incur substantial costs from firing a firm and looking for another one.²⁰ Even if large firms generally have substantial reputational capital, a client may not easily be able to trust a particular firm to meet its particular needs. Law firms therefore can count on long-standing repeat business from large corporate clients.

Galanter & Palay, *supra* n. 15 at 9-10; William Henderson, *Part II: How Most Law Firms Misapply the "Cravath System"*, LEGAL. PROF. BLOG, July 29, 2008, http://lawprofessors.typepad.com/legal_profession/2008/07/part-ii-how-mos.html.

¹⁸ See Ronald J. Gilson *The Devolution of the Legal Profession: A Demand Side Perspective*, 49 MD. L. REV. 869 (1990).

¹⁹ This helps explain why referrals are permitted within law firms but not outside them. Gilson argues that the client is also protected by its continuing relationship with the rainmaker. *Id.* at 896. However, the firm's reputation protects the client who has a longstanding relationship with the firm rather than with particular partners in the firm. Gilson & Mnookin, *supra* note 10 at 349-52, also argue that the kickback incentive is muted by how income is allocated within the firm between the rainmaker and the specialist. But this allocation is, in turn, shaped by the firm's incentive to structure incentives to protect its reputation.

²⁰ See Gilson, *supra* note 18 at 897-99.

Gilson's theory, however, does not fully explain why law firms have grown so large. Although it is easy to see why clients would want to deal with firms with many specialists, it is not clear why these firms need to have hundreds of partners and associates. One answer to this question is that legal work often involves a peak load problem. Corporations' legal needs are too variable and unpredictable to make it practicable to have on hand all of the legal support they need. Clients may need law firms to undertake on short notice such demanding work as legal research, document review, legal advice on complex issues and multiple court appearances in connection with litigation and acquisitions. Sophisticated work on large transactions or litigation may call for lawyers with different specialties, non-lawyer experts and costly technology. Large firms can keep sufficient human and technical resources on call to meet these needs because they can amortize the cost across many clients and cases.

Large firms' ability to meet the peak load problem is not, however, a sufficient explanation for large law firms because clients theoretically can enter into spot contracts for the services they need. Clients might outsource needs such as legal research, contract review or document handling, or hire smaller law firms and let these law firms outsource to meet peak load demands. To be sure, repeated negotiation and pricing of these contracts may be costly. Coase used these costs to explain the formation of firms.²¹ But clients and law firms could mitigate these costs by making long-term contracts that do not require a single firm to own hard assets or employ a lot of lawyers full time.

The problem with spot or even long-term contracting for specific services is that it may not provide clients with the quality assurances they need. Thus, the reputational bonding theory returns to explain why clients would prefer a long-term relationship with a firm on which the client can rely to monitor a potentially shifting stock of specialists and support workers.

Beardslee, Nanda & Coates suggest a theory of "legal capacity insurance" to explain why corporations need to maintain relationships with outside law firms rather than relying on in-house counsel and spot-contracting.²² Because clients' needs are likely to be correlated with those of rivals, firms need to develop long-term relationships with several "preferred providers" that will implicitly promise clients access to their services, and which clients can trust based on past experience and reputation. This helps bind clients to particular firms.

A problem with this "legal capacity insurance" explanation of Big Law is that corporations could alternatively rely on networks of specialists who work alone or with different firms. The benefits of being able to rely on a large firm's lasting reputation and

²¹ See Ronald H. Coase, *The Nature of the Firm*, 4 *ECONOMICA* 386 (1937), reprinted in *THE NATURE OF THE FIRM: ORIGINS, EVOLUTION, AND DEVELOPMENT* 18 (Oliver E. Williamson & Sidney G. Winter eds., 1991).

²² See Michele DeStefano Beardslee, Ashish Nanda, & John C. Coates, IV, *Hiring Teams from Rivals: Theory and Evidence on the Evolving Relationships in the Corporate Legal Market*, (June 22, 2009), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1442066.

substantial support services must be compared with those of having the flexibility and market discipline of alternative suppliers.

In short, while there are theoretical reasons why clients would rely on Big Law, large law firms also compete on the margin with alternative suppliers of similar services. The rest of this Part shows why these alternatives are becoming increasingly attractive.

D. BIG LAW'S FRAGILE EQUILIBRIUM

So far this Part has explained how Big Law can produce reputational capital and why clients may be willing to pay for it. The problem is that the value of reputational capital can be quite fragile since it depends both on the firm's sustaining it and clients needing it. As we have seen, the firm's reputation lasts only as long as lawyers gain more from investing in it than they do from building their own clienteles. This, in turn, will be the case only as long as large firms can attract and bind major corporate clients.

Big Law's value therefore is vulnerable to rapid unraveling when the forces binding lawyers and clients to the firm weaken. Law partners also may face a prisoner's dilemma when their confidence in the firm wanes. If they suspect their partners will not continue to be loyal, they may choose to "grab" clients and leave the firm or focus on preserving their exit route by building their clientele even if they would have come out better by working to build the firm.²³ Shifting expectations can quickly change the firm dynamic from cooperation to competition.

Grabbing and leaving is only part of a vicious cycle that is threatening law firm stability. More lateral movement among firms increases firms' need to recruit laterals as opposed to training associates, particularly among less profitable firms.²⁴ As firms' reputational capital declines they must rely more on hiring rainmakers to generate business. This, in turn, puts significant short-term pressure on firms to increase associate leverage and billable hours even if a more viable long-term strategy would be to focus on achieving greater efficiency and quality control.

E. PRESSURES ON BIG LAW

Given the inherent vulnerability of the reputational capital model, even a little market pressure on the model can threaten its survival. This subpart discusses the factors that combine to destabilize Big Law's already fragile ecosystem. As the national data cited at the beginning of this article indicate, Big Law has been shrinking. It is too early to know whether profits will go back up with the economy, or whether any lag in recovery of law firm profits is attributable to a long-term decline in client demand. However, the factors discussed below indicate a long-term demand decline, perhaps masked by a bubble-induced spike in deals prior to the 2008-2009 financial meltdown.

²³ The seminal article on "grabbing and leaving" is Robert W. Hillman, *Law Firms and Their Partners: The Law and Ethics of Grabbing and Leaving*, 67 TEXAS L. REV. 1 (1988). See also, Milton C. Regan, Jr., *Law Firms, Competition Penalties, and the Values of Professionalism*, 13 Geo. J. Legal Ethics 1 (1999).

²⁴ See Henderson & Bierman, *supra* note 17.

1. The rise of in-house counsel

The reputational capital model of Big Law assumes clients need help judging the quality of legal services. However, large corporate clients have an alternative to buying expertise from outside firms. As with any input, the alternative to buying outside is “making” in-house – in this case by hiring in-house counsel to provide direct legal advice and information about outside lawyers. When clients have the technical expertise to dispense with specialists and can figure out on their own which individual lawyers are reliable and meet their specific needs, they will have less need to buy outside legal services based on personal relationships with individual lawyers or to rely on a stable of “preferred provider” Big Law firms.²⁵ The increased role of in-house counsel is therefore a significant threat to the future of Big Law.²⁶

The rise of in-house counsel is itself at least partly a response to the other developments discussed in this article. The supply-side pressures on law firms to increase prices discussed above increase firms’ incentive to invest in developing their in-house legal departments. As these departments get larger, the marginal costs of giving them more work decrease.

In-house counsel’s ability to surmount information asymmetry problems in legal representation does not necessarily mean that corporations can dispense with outside lawyers. Corporations likely will remain constrained by limits on their ability to monitor professional services and to staff to handle peak loads.

The important question for present purposes is not whether corporations will continue to buy outside legal services, but whether they will continue to rely on Big Law. Although there is evidence that corporations still rely on long-term experience and relationships in engaging outside law firms and rarely fire their long-term firms, some corporate legal officers are aggressive in frequently switching law firms.²⁷ Also, corporations apparently are relying on teams of lawyers rather than firms.²⁸ Indeed, as discussed below, recent breakups of Big Law firms indicate a trend toward movement of practice groups even as firms dissolve. Thus, even if corporations are not moving legal work inside, they may be reducing their reliance on big law firms. This could reflect corporate legal officers’ skepticism about Big Law’s ability to deliver the long-lived reputational bond and “capacity insurance” that allegedly sustain these firms. This skepticism is further supported by other developments discussed below that are eroding traditional Big Law advantages.

²⁵ See *supra* text accompanying note 22.

²⁶ See Thomas Morgan, *THE VANISHING AMERICAN LAWYER*, 114 (2010) (noting that 25% of lawyers are employed in single client situations, of which 40% are inside corporate counsel); Gilson, *supra* note 18 at 901-02 and n. 75 (arguing that the increase in client sophistication from the rise of in-house counsel “predicts a dramatic change in the pattern of client relationships and firm structure” and that “the national law firm may be an idea whose time has come and gone”).

²⁷ See Beardslee, et al, *supra* note 22.

²⁸ *Id.*

2. Reduced size and scale advantage

Big Law gets some of its competitive advantage from its ability to mobilize on short notice substantial human and technical resources, particularly including legal research and document storage and retrieval. Computerized legal research, fast Internet connections and declining costs of data storage and retrieval decline have eroded some of Big Law's scale advantage.

3. Increasing partner-associate ratios

Big law firms have found that they can increase the number of associates whose billings produce profits without commensurately increasing the number of partners who share these profits. In the short term this enables firms to hire star rainmakers who bring in lucrative business. However, the growth has several long-term costs that have threatened the viability of the large law firm.

One problem with the strategy of increasing profits by growing the number of associates is that the firm's profitability may not actually be increasing once risk is taken into account. Hiring more associates paid with fixed salaries is analogous to borrowing at fixed interest rates. In both cases leverage magnifies the effect of future losses as well as profits. The firm has to pay its associates, just as it must repay its debt, in bad times as in good. Thus, law firms, like other firms, cannot necessarily increase their value just by changing their capital structure.²⁹

Increasing the ratio of associates to partners can reduce the value of the firm's reputational capital. As discussed above, an important potential advantage of law firms is that their partnership structure, equal financial sharing, up-or-out promotion policies and vicarious liability, helps ensure that they can maintain their reputations for high quality and good faith service. However, adding associates may undermine this structure. In order to maintain their per-partner profits, firms cannot start promoting or firing large numbers of associates.³⁰ Instead, Big Law has replaced the classic tournament with what has been called an "elastic tournament" in which firms keep the associates as employees.³¹ This reduces the role of the tournament as a mechanism for screening and training new partners.

Increasing associate leveraging also pressures law firms to change their business mix in ways that may reduce their long-term value. In order to keep their associates working and billing hours, firms have branched into work like structured finance, which

²⁹ See Franco Modigliani & Merton Miller, *The Cost of Capital, Corporation Finance and the Theory of Investment*, 48 AM. ECON. REV. 261 (1958).

³⁰ With respect to promotions, see Nate Raymond, *Law Firms Promote Fewer Senior Associates to Partnership*, N.Y. Law Journal, November 30, 2009, <http://www.law.com/jsp/article.jsp?id=1202435897457> (noting evidence that law firms are reducing promotions, and quoting a law firm consultant that "[p]rofits are squeezed at big firms this year, and they don't want to dilute partnership income any more than they have to").

³¹ See Marc Galanter & William Henderson, *The Elastic Tournament: A Second Transformation of the Big Law Firm*, 60 STAN. L. REV. 1867 (2008).

lent itself to large amounts of routine work and significant economies of scale.³² Some of this work could be sent down the labor food chain to contract attorneys, outsourcers, or even to machines.³³ This makes Big Law more vulnerable to competition from suppliers that do not need Big Law's high-cost reputational capital.

4. Changing clientele

Big Law's "capacity insurance" function³⁴ might point to a limited future. Only a limited class of clients and transactions needs this insurance – that is, large diversified financial institutions and participants in big financial transactions, mergers and acquisitions. Large acquisitions, which involve myriad contractual and regulatory issues and need to be handled on a fast yet customized basis, are the classic Big Law transaction because they require large teams of lawyers from multiple departments. For example, Comcast's \$30 billion purchase of control of NBC Universal from General Electric took 79 lawyers – 38 from Comcast's firm, Davis Polk & Wardwell, which provided corporate, tax, real estate and intellectual property advice from two offices on the resulting complex joint venture, ten from Gibson Dunn & Crutcher on behalf of minority seller Vivendi, 30 from Weil, Gotshal & Manges on behalf of GE and NBC Universal.³⁵ It is hard for a single lawyer to walk out the door with this type of business. Thus, financial firms traditionally have had long-lasting relationships with large firms such as Goldman with Sullivan & Cromwell, JP Morgan with Davis Polk, and Cleary with Salomon.

Acquisition activity may be a threat as well as a boon to big law. Mergers and other restructuring, particularly in the financial services industry, can unsettle client relationships by constantly changing management. These developments affect the durability and therefore value of Big Law's client relationships. Moreover, over the long term, thicker markets may be reducing the need for the sort of large, vertically integrated companies that need the services of the largest law firms.³⁶

If large law firms lose the "capacity insurance" business, their value and durability may decline. Clients that just need high-quality advice by individual lawyers or teams of lawyers will need relationships with these individuals and networks rather than with large, multiservice firms. Moreover, as Big Law's traditional clients become less "sticky," firms may have to rely more on rainmakers to attract new business.

³² Indeed, one firm, Thacher Proffitt & Wood, took the lead in this work, only to crash quickly when the work was washed away by the financial meltdown. See *infra* text accompanying note 82.

³³ See *infra* text accompanying notes 106-107.

³⁴ See *supra* text accompanying note 22.

³⁵ See Michael Corkery, Comcast-NBC Universal Deal Is a Legal Boomlet, Wall St. J., December 3, 2009, <http://online.wsj.com/article/SB10001424052748703735004574574283775883214.html>

³⁶ See Larry E. Ribstein, THE RISE OF THE UNINCORPORATION, 234-35 (2009).

5. Limited liability

The reputational bonding model of Big Law traditionally has been supported by law partners' traditional vicarious liability for their firms' debts.³⁷ Personally liable partners have an incentive to monitor co-partners and associates and guard against taking on business that could significantly increase the firm's risk of malpractice or regulatory liability.³⁸

Large firms, however, have moved to limited liability structures. This resulted partly from increasing regulation. Until the late 1980s, uninsured malpractice liability rarely if ever threatened large firms' viability or their partners' pocketbooks. The potentially ruinous professional liabilities associated with the savings and loan collapses of the late 1980s and early 1990s increased the likelihood of individual partner liability, and therefore motivated them to change bar rules to permit law firms to adopt limited liability. The development in Texas (the epicenter of the savings and loan collapse) of the limited liability partnership eased law firms' path to limited liability by enabling them to adopt limited liability while technically remaining general partnerships.³⁹

Limited liability made it easier for Big Law to expand over the last twenty years. At the same time, limited liability may have weakened Big Law internally. Limited liability increases lawyers' incentive to gamble with the firm's reputation by hiring more associates than the firm can effectively screen and monitor. Limited liability also may have contributed to destabilizing Big Law. Lawyers who are personally liable for their firms' debts have an incentive to try to rehabilitate a declining firm rather than risking being jointly and severally liable for the firm's unpaid debts.⁴⁰ By contrast, lawyers with limited liability can jump ship without worrying the firm's liabilities will follow them.⁴¹

³⁷ See *supra* section I.B.4.

³⁸ See generally Larry E. Ribstein, *Limited Liability of Professional Firms after Enron*, 29 J. CORP. L. 427 (2004).

³⁹ See Alan R. Bromberg & Larry E. Ribstein, BROMBERG & RIBSTEIN ON LLPS AND RUPA, §1.01 (discussing the history of the LLP).

⁴⁰ See Alan R. Bromberg & Larry E. Ribstein, BROMBERG & RIBSTEIN ON PARTNERSHIP, §7.14 (discussing continuing partner liability for dissolved firm's debts).

⁴¹ Lawyers' ability to exit is constrained to some extent by the potential for fraudulent conveyance liability for distributions while the firm is insolvent. See 11 U.S.C. § 548(b) (providing for recovery of fraudulent transfers by partnerships); Bromberg & Ribstein, *supra* note 39, §7.02. For example, former partners of Brobeck, Phleger & Harrison agreed to pay more than \$22 million to settle claims arising out of payment to these partners of distributions and bonuses while the firm was insolvent. See Sandburg, *The Recorder*, February 23, 2005, available at <http://www.law.com/jsp/article.jsp?id=1109120820688>.

Limited liability theoretically could contribute to law firm stability by helping them grow larger, since the survival of a small firm is more easily threatened by departure of a few clients or partners. In this sense, limited liability arguably increases the durability and value of a law firm's reputational capital. See Ribstein, *supra* note 4 at ___. However, reduced stability may dominate to the extent that limited liability weakens the firms internally, as the Text suggests.

The effect of limited liability is complicated by states' qualification of liability protection by holding law partners liable for failure to supervise. Unlike full-fledged vicarious liability, lawyers can avoid this liability by not engaging in certain general types of supervisory activities.⁴² Partial limited liability therefore can have the effect of reducing firms' internal monitoring even as compared with complete limited liability.⁴³

To be sure, the relationship between vicarious liability and reputational capital is not completely straightforward. Liability is only one element in firms' reputation-maintenance efforts, since acts that trigger liability lie on the outer tail of threats to firms' reputations. But vicarious liability nevertheless helps ensure vigilance even by partners who otherwise might be inclined to stress their own clients over their monitoring obligations to the firm.

6. Increasing global competition

Big Law operates within a margin defined in part by global competition. Clients may come to wonder why they should pay large fees to sustain Big Law's profits, and thereby its fragile financial structure, when they can spend less to hire equally skilled lawyers in other countries.

One source of global competition is the emergence of global legal and financial centers such as London, Singapore, and Hong Kong that compete with New York, where Big Law traditionally has dominated. These centers are attracting financial work that, as discussed above, has been a mainstay of Big Law business. This became evident when, after Sarbanes-Oxley increased U.S. regulation of foreign firms cross-listing in U.S. markets, substantial securities business and associated legal work moved from New York to other markets, particularly including London.⁴⁴

Another threat to Big Law is the outsourcing of legal services to India and other places with lower labor costs than the U.S.⁴⁵ For example, Manthan, a 300-lawyer outsourcing firm that does work for Big Law and medium-sized firms, charges fixed fees that can be significantly lower than associate time for comparable work.⁴⁶ Fronterion,

⁴² See *id.* § 3.04(c).

⁴³ See Ribstein, *supra* note 4 at ___.

⁴⁴ See Joseph D. Piotroski & Suraj Srinivasan, *Regulation and Bonding: The Sarbanes-Oxley Act and the Flow of International Listings* (January 1, 2008), Rock Center for Corporate Governance at Stanford University Working Paper No. 11, <http://ssrn.com/abstract=956987> (finding that the likelihood that small firms would choose to list in the U.S. on NASDAQ rather than the London Stock Exchange's Alternative Investment Market decreased following the enactment of Sarbanes-Oxley).

⁴⁵ See Jayanth K. Krishnan, *Outsourcing and the Globalizing Legal Profession*, 48 WM. & MARY L. REV. 2189 (2007) (analyzing the nature of increasing outsourcing of American legal work to India); David A. Steiger, *The Rise of Global Legal Sourcing*, BUS. L. TODAY, Volume 19, Number 2 November/December 2009.

⁴⁶ See David Lat & Elie Mystal, Above the Law, *Outsourcing: What Indian Firms Have Planned for the Future of Biglaw* (June 9, 2009), http://abovethelaw.com/2009/06/outsourcing_what_indian_firms.php.

L.L.C. advises law firms and corporations with independent advice on legal outsourcing strategies and firms.⁴⁷ Shifting work from Big Law associates working in large U.S. cities to India could threaten the traditional Big Law model of leveraging substantial associate hourly billing into partner profits. Moreover, U.S. corporations and law firms could adopt some of outsourcing firms' cost-control management processes, which might put pressure on Big Law profits.

To be sure, legal outsourcing currently focuses on the commodity end of legal work, including risk management, contract review and patent searches, rather than the sophisticated transactional work that is Big Law's comparative advantage. However, as Big Law has moved to this work to keep its pipeline filled⁴⁸ it has become more vulnerable to competition from commodity suppliers. Also, the legal outsourcing industry is dynamic. It has already created a significant supply of global legal services that could be tapped to serve a broader market. Its future growth depends to some extent on the development of new technologies for monitoring outsourcers.⁴⁹

Big Law's clients themselves theoretically could hire cheaper foreign lawyers and avoid the middleman of a U.S. law firm. This practice is currently limited by the fact that outsourced lawyers are not licensed in the U.S. to represent U.S. clients. Big Law avoids this problem through a rule that enables lawyers to outsource as long as they exercise reasonable supervision over the supplier.⁵⁰ However, corporate clients could exercise comparable supervision through in-house counsel, which already hire outsourcers to assist them in their own work. This could effectively expand the capacity of in-house counsel offices and reduce the amount of work clients need to send to outside lawyers.

7. Deprofessionalization of law practice

U.S. lawyers have created a special professional niche through regulation that protects them from open-ended competition by allowing only those licensed by a state to practice law to represent clients residing in that state and appear in that state's courts.⁵¹ These laws are essential to Big Law's continued survival in its current form. By ensuring that legal advice, a key element in every transaction in a highly regulated economy, can be rendered only by lawyers, they preserve the pivotal role of law-only firms in transactional work. Licensing laws also back attorney ethical rules that dictate Big Law's organizational structure by restricting outside financing, noncompetition agreements and state competition regarding regulation of law firm structure.⁵²

⁴⁷ See <http://www.fronterion.com/>.

⁴⁸ See *infra* text accompanying note 82.

⁴⁹ See George S. Geis, *Business Outsourcing and the Agency Cost Problem*, 82 N.D. L. REV. 955 (2007) (discussing how outsourcing is increasing with the reduction in monitoring costs).

⁵⁰ See ABA Standing Committee on Ethics and Professional Responsibility, Formal Opinion 08-451 (Aug. 5, 2008); Ass'n Bar City of N.Y., Opinion 2006-3 (Aug. 2006).

⁵¹ See *infra* subpart III.C.

⁵² See *infra* Part III.

The general role of licensing in protecting lawyers⁵³ and competition's threat to licensing requirements⁵⁴ are discussed below. This section focuses on the specific threat to Big Law from the erosion of licensing requirements. First, multijurisdictional law firms strike at licensing by individual states. Under current law lawyers may not represent clients or practice in courts in states where they are not license to practice. Yet the increasing demands of interstate and international business make it hard to confine lawyers' work within specific geographic spaces. Licensing rules have evolved to some extent to accommodate these demands by letting lawyers do significant work outside states in which they are licensed. Several states have special rules or practices permitting lawyers who are not admitted locally to act in some capacities as in-house corporate counsel.⁵⁵ Also, lawyers can work in their firms' branch offices outside their home states without being locally admitted.⁵⁶ These practices ultimately could erode each state's power to license lawyers. States might officially concede the game and agree to a "driver's license" approach in which a lawyer licensed in one state may practice everywhere.

Second, corporations increasingly are relying on their own employees for important legal advice, as discussed above.⁵⁷ This phenomenon erodes lawyers' distinct professional status. The rising costs of litigation and Big Law could overcome the remaining constraints on firms' bringing legal work inside. Legal-type work also could diffuse throughout the organization, blurring distinctions between professional lawyers and non-lawyers whose work deals with law.⁵⁸

Third, even if firms do not bring legal work inside, the rising costs of legal representation may push clients to explore outside alternatives to law firms such as non-lawyer law consultants,⁵⁹ accounting and economic consulting firms,⁶⁰ and mechanized legal advice through sophisticated software.⁶¹

⁵³ See *infra* section III.A.3.

⁵⁴ See *infra* section III.B.1.

⁵⁵ See generally *Center for Professional Responsibility, Corporate Admissions Standards*, <http://www.abanet.org/cpr/mjp/mjp-uplchart.html> (chart tabulating state rules on practice by in-house counsel, listing about a dozen states with such rules).

⁵⁶ See Wolfram, *supra* note 4, § 15.4.1, at 868-69.

⁵⁷ See *supra* section I.D.1.

⁵⁸ See Herbert M. Kritzer, *The Future Role of "Law Workers": Rethinking the Forms of Legal Practice and the Scope of Legal Education*, 44 ARIZ. L. REV. 917 (2002).

⁵⁹ See Tanina Rostain, *The Emergence of "Law Consultants,"* 75 FORDHAM L. REV. 1397 (2006).

⁶⁰ See *infra* II.F.2.

⁶¹ See Larry E. Ribstein, *Lawyers as Lawmakers: A Theory of Lawyer Licensing*, 69 Mo. L. Rev. 299 (2004) (discussing the shifting boundaries of unauthorized practice, particularly as a result of technological innovations).

8. The decline of hourly billing

Big Law's business model is built significantly on how it charges for its services – that is, by the hour. This mode of pricing is odd. Clients do not buy lawyer hours anymore than customers buy the hours spent on building a car. Clients buy solutions to legal problems. Time spent usually is not even a rough proxy for the value of this product. An attorney may spend days on fruitless research or document review but have a quick flash of insight that wins the case or makes the transaction successful.

One explanation for time-based billing is that it represents a rough compromise of lawyers' and clients' needs. Hourly billing gives firms a simple way to monitor their lawyers.⁶² As long as clients are willing to pay for each hour billed, law firms have a luxury few other firms have of determining their employees' productivity by precisely matching readily observable inputs (time) with revenues. From clients' standpoint, hourly billing at least provides more assurance than a simple bill "for services rendered."

The problem with hourly billing for clients is that, while it may seem to give them more accountability than billing by the job, the assurance is misleading if clients have no way of knowing how many hours were necessary to do the job well.⁶³ After all, clients hire lawyers precisely because clients are not legal experts. Hourly billing therefore can exacerbate lawyer-client agency costs because it tempts law firms to spend unnecessary time and client money. This temptation has increased as a result of associate leveraging through which law firms build revenues, and therefore profits per partner, by hiring more associates and having them bill more hours. The current pressures on Big Law reduce their incentives to try to build long-term goodwill by exploring alternative billing mechanisms.

Given these obvious problems with hourly billing, it is logical to look for explanations of its persistence other than lawyer and client convenience. One promising explanation is that the hourly fee is a function of the law firm's reputational capital.⁶⁴ Specifically, given the risk of law firm cheating from overbilling hours, only firms with substantial reputations can get away with charging by the hour. At the same time, these firms attract more complex work for which the number of hours required may be substantial and uncertain. Indeed, there is survey evidence associating hourly billing (as well as high flat fees) with higher law firm reputation.⁶⁵

In light of this evidence linking hourly billing and law firm reputation, one might expect the billable hour to decline with the dissipation of Big Law's reputational

⁶² See Fred S. McChesney, *Team Production, Monitoring, and Profit Sharing in Law Firms: An Alternative Hypothesis*, 11 J. LEGAL STUD. 379 (1982) (showing high correlation between hours billed and compensation).

⁶³ See Nuno Garoupa & Fernando Gomez-Pomar, *Cashing by the Hour: Why Large Law Firms Prefer Hourly Fees Over Contingent Fees*, 24 J. L. ECON. & ORG. 458 (2008).

⁶⁴ See Janet K. Smith & Steven R. Cox, *The Pricing of Legal Services: A Contractual Solution to the Problem of Bilateral Opportunism*, 14 J. LEG. STUD. 167 (1985).

⁶⁵ *Id.*

capital.⁶⁶ It would also follow that the same forces discussed above that are eroding Big Law's competitive advantages reduce its ability to rely on the billable hour. This includes clients' increased sophistication and information, particularly as their in-house legal departments develop,⁶⁷ and competition by outsourcing and other firms offering superior revenue models. Indeed, some firms have long mixed hourly billing with such approaches as performance bonuses,⁶⁸ contingent and flat fees, and law firm equity investments in clients.⁶⁹ There is recent evidence in the hard times of 2008-2009 that clients have pressured firms to offer flat fee billing for many services.⁷⁰

Law firms may tend to view these developments as a temporary effect of current economic forces. But while hard times may affect the *level* of prices, they cannot be completely responsible for a change in pricing *methods*. Firms also might see alternative billing as affecting only relatively small parts of their practice, and not reaching more sophisticated and unpredictable work, such as complex litigation. However, firms theoretically can break down even the most complex projects into discrete tasks as to which lawyers and clients have enough experience to charge on some basis other than counting hours.

The decline of hourly billing could have important effects on the structure of Big Law. Law firms no longer would have the luxury of simply throwing more time into projects for which they can expect to get paid. This, in turn, could affect Big Law's labor

⁶⁶ See Bruce MacEwen, *The Billable Hour Debate Is Not About the Billable Hour*, Adam Smith, Esq. August 24, 2009, <http://www.adamsmithesq.com/archives/2009/08/the-billable-hour-debate-is-not-about-the-billable-hour.html> (arguing that the billable hour ultimately may become a casualty of several forces, including increased client mistrust).

⁶⁷ See *supra* section I.D.1.

⁶⁸ See Lincoln Caplan, *SKADDEN: POWER, MONEY, AND THE RISE OF A LEGAL EMPIRE*, 102-04 (1993).

⁶⁹ This practice was prevalent during the tech boom in Silicon Valley. A leading example was Craig Johnson's Venture Law Group not only provided legal services, but also gave business advice and served as an intermediary in obtaining financing, taking sometimes lucrative equity positions in the startups in lieu of fees. See Stephen Miller, "Lawyer's Twist on the Firm Tapped Into Start-Up Frenzy," *Wall S. J.*, October 8, 2009 at A16, <http://online.wsj.com/article/SB125486675503468885.html>; Larry E. Ribstein, *Ideoblog*, "Craig Johnson's new model for law practice," October 7, 2009, <http://busmovie.typepad.com/ideoblog/2009/10/craig-johnsons-new-model-for-law-practice.html>. Wilson Sonsini also has had a lucrative investment fund in which partners were required to invest according to their stakes in the law firm, as well as funds for voluntary investments. See Zusha Elinson, *An Inside View of Wilson Sonsini's Fabled Investment Fund* *The Recorder* (December 7, 2009), <http://www.law.com/jsp/article.jsp?id=1202436088682>. For a policy analysis of lawyer investments in clients, see Christine Hurt, *Counselor, Gatekeeper, Shareholder, Thief: Why Attorneys Who Invest In Their Clients in a Post-Enron World Are "Selling Out," Not "Buying In"*, 64 *OHIO ST. L.J.* 897 (2003). Ethical rules permit the investments as long as the transaction is fair and the client gets full disclosure. See Rule 1.8, Model Rules of Professional Conduct.

⁷⁰ See Nathan Koppel and Ashby Jones, "Billable Hour' Under Attack In Recession, Companies Push Law Firms for Flat-Fee Contracts," *Wall St. J.*, August 24, 2009 at A1, http://online.wsj.com/article/SB125106954159552335.html#mod=todays_us_page_one (noting survey of Fortune 1000 companies showing that money spent on alternative billing arrangements rose to \$13.1 billion in 2009 from \$8.6 billion in previous year).

pool. Big Law has been able to justify high hourly rates for associates in part by hiring associates with the right law school pedigrees. This has driven up the cost of talent, as Big Law recruits from a sliver of the overall labor market. The cost pressures resulting from fixed fees may force Big Law to be more creative about hiring and training talent. Moreover, as fixed fees replace monitoring of number of hours and hourly rates, law firms have an incentive to get more efficient work out of higher-paid senior lawyers.⁷¹ A shift from hourly billing also contributes to and reflects the commodification of law practice. Firms may evolve from rendering specialized services to delivering products. This meshes with the alternative business models discussed below in Part II, including trends toward legal products and research and development.

F. THE UNRAVELING OF BIG LAW

This subpart summarizes some effects of the problems and developments discussed above in this Part – that is, the death and shrinkage (through layoffs and deferrals) of Big Law, and the “devolution” of big law firms into smaller and less hierarchical firms that more closely resemble the classic equal partnership discussed at the beginning of the article.

1. Case histories

It is instructive to review press accounts of some of the more notable law firm failures over the last several years for signs of the inherent problems in Big Law discussed above.

Brobeck, Phleger & Harrison. This firm tried to transform itself into a big business and failed spectacularly. Under the leadership of high profile managing partner Tower Snow, Jr., Brobeck focused on high-margin areas of business, poured money into marketing, replaced the standard law firm worker cooperative with “Russian-style centralized management system,” expanded from 540 to 754 lawyers in one year (summer 1999 to summer 2000), and raised associate salaries before entering bankruptcy in January, 2003.⁷² When the tech bust hit the firm’s core practice, revenues dropped precipitously, 60 partners left in 2002, and the firm was left with significant debt and excess office space.⁷³ A post-mortem in mid-2003 viewed Brobeck’s spectacular unraveling as a one-off symptom of a firm with runaway growth, lack of culture, too much debt, and weak bonds with clients, and confidently predicted that there are not “more Brobecks waiting in the wings.”⁷⁴ However, in some respects Brobeck’s failure was a glimpse of the future.

Alzheimer & Gray. This venerable Chicago firm rapidly declined into bankruptcy in June, 2003 in the face of a deteriorating corporate climate (the firm

⁷¹ See Koppel & Jones, *supra* note 70 (discussing effect of Pfizer’s switching to fixed fee billing).

⁷² See Susan Beck, “The Harder They Fall, AMERICAN LAWYER, August, 2002 at 65.

⁷³ See Susan Beck, “Brobeck’s Final Days,” AMERICAN LAWYER, March 2003 at 13.

⁷⁴ See Peter B. Zeughauser, “Your Future is at State,” AMERICAN LAWYER, May, 2003 at 49.

specialized in corporate and real estate), and, like Brobeck, over-commitment to office space.⁷⁵

Arter & Hadden. This Cleveland firm rapidly expanded outside of its base, going from 70 to 465 lawyers in the 1980s and 1990s. The new lawyers proved to have weak ties with their new firm and quickly left “just like they left one place to come to Arter & Hadden.” A partner observed that “the notion of making even a short-term or a medium term financial sacrifice for some greater good of the firm is just not how a lot of folks are wired.” When the firm shut down in July, 2003, 68 lawyers in the Cleveland office moved as a group to a new firm. A partner noted that “[t]he partners here wanted to be partners with this group of people and continue to practice with one another and with this group of clients.”⁷⁶

Coudert Brothers This global firm faced the problem of “operating in different economic environments with different risks.”⁷⁷ When the firm voted to dissolve in August, 2005, “most Coudert partners jumped in groups.”⁷⁸

Thelen, Reid and Heller Ehrman. The voluntary dissolutions of these firms in September and December 2008 were attributed to the lack of professional leadership, attempts to expand with negative effects on the firms’ culture, and too much debt.⁷⁹ Thelen faced pressure to liquidate from a big lender.⁸⁰ Heller’s management botched an expansion plan, the firm started losing partners, and the en masse departure of fourteen intellectual property litigators triggered notice provisions in the firm’s lending agreement, forcing the firm to dissolve.⁸¹

Thacher Profitt & Wood. This old-line firm veered into structured finance after 1978, ultimately specializing in it. The work was attractive because “a few partners supervising a large number of associates could generate enormous revenues.”⁸² The firm expanded from 177 lawyers in 2003 to 350 in 2007, by which time structured finance was 40-55% of revenues (70% including real estate), and the associate-partner ratio was 6:1. The firm was then decimated by the bursting of the subprime bubble. Ultimately

⁷⁵ See Eric Herman, “Alzheimer partners agree to pay \$16 mil.; Bankruptcy plan outlines who pays, who will be paid,” CHICAGO SUN-TIMES, December 29, 2004 at ___.

⁷⁶ Alison Grant, “Lawyers, creditors resolve dispute \$10 million to be paid in firm’s bankruptcy,” CLEVELAND PLAIN DEALER, April 7, 2007 at C1.

⁷⁷ Ellen Rosen “The Complicated End of an Ex-Law Firm,” N.Y. TIMES, February 9, 2007 at C_ (quoting Ward Bower of Altman Weil).

⁷⁸ Carlyn Kolker, “An Unquiet Death,” AMERICAN LAWYER, November, 2006 at 78.

⁷⁹ Richard Gary, “Lessons Learned: Examining the Dissolution of Heller Ehrman and Thelen,” THE RECORDER, vol 123, no. 216 (November 5, 2008).

⁸⁰ Carolyn Okomo, “Thelen becomes latest law firm bankruptcy,” DAILY DEAL, September 23, 2009.

⁸¹ Drew Combs, “Why Heller Died,” AMERICAN LAWYER, November, 2008 at 81.

⁸² David Bario, “A Really Bad Bet,” AMERICAN LAWYER, March, 2009 at 84.

covenants in debt incurred to house the new personnel were triggered, forcing the firm to attempt to scramble for a merger and ultimately dissolve in December 2008, despite the fact that the firm's "core very much wanted to stay together."⁸³

Wolf , Block , Schorr & Solis-Cohen. The immediate causes of this venerable Philadelphia firm's voluntary dissolution in March, 2009 were those familiar from the above stories – the departures of top partners and a credit crunch.⁸⁴ Digging a little deeper, the firm was undiversified, and therefore vulnerable to a decline of its core real estate business, and lacked strong connections among attorneys and practice groups.⁸⁵

2. General observations

Here are some notable features that emerge from the above stories:

1. Although these cases cover the last six years, they share many of the same features. This supports the point of this paper that Big Law suffers from an internal weakness and not just the effects of the most recent global economic meltdown.

2. These firms had no internal binding force. Partners left when current revenues could not bind them to their firms.

3. Several of the firms fractured into practice groups, which joined other firms. This suggests that the ties among law partners are personal networks rather than capital belonging to the firm as such.

4. Most of the firms had attempted to add revenues by rapidly adding lawyers. However, the expansions did not strengthen the firms, and they broke down rapidly when business declined. This suggests that, rather than being triggered by success, the expansions reflected the inherent weakness of the firms' business model – their lack of reputational capital or other productive assets. Adding more lawyers not only cannot provide that firm-based property, but can actually weaken it further.

5. Many of these firms were vulnerable to an economic downturn in a given business sector because of their lack of diversification. The problem is not that the firms simply failed to recognize the potential risk-reduction benefits of diversification,⁸⁶ but that diversification requires the firm to have reputational capital that can bind lawyers in hot practice areas to the sharing deal.

6. Several firms financed expansion with bank debt and rapidly failed when a business decline interacted with a credit crunch and triggering of loan covenants. The problem is not just the debt itself, but the facts that the debt financed unproductive

⁸³ *Id.*

⁸⁴ Chris Mondics, "Partners vote to end Wolf Block, PHILA. INQ., March 24, 2009 at A1.

⁸⁵ Susan Letterman White, "What can we learn from the implosion of Wolf Block,?" LEGAL INTELLIGENCER, vol. 239, no. 82, April 29, 2009, at 5.

⁸⁶ *See supra* text accompanying note 12.

expansion (see point 4), the firms were forced to over-leverage because they could not raise equity capital other than from their partners, and the partners lacked commitment to their firms (see point 2).

3. Devolution

The pressures on Big Law discussed above in this Part have caused not only the death and shrinkage of Big Law, but also the emergence from Big Law's ashes of smaller firms that seem to be little more than aggregates of individual lawyers. Law firms therefore seem to be devolving back to the pre-Big-Law model of law practice in which lawyers are bound by personal ties rather than working for large institutions. This reflects these institutions' lack of a viable business model.

Henderson & Bierman spotlight this fundamental shift by presenting evidence that mid-range firms have struggled to remain competitive with the top tier by hiring laterally.⁸⁷ They show that lateral hiring is greatest at firms that have only average profitability rather than at the most profitable firms, which could be expected to attract the best lawyers. These average firms also increased associate leverage and expanded geographically. This suggests that these firms in effect are buying business by expanding and hiring rainmakers and generating profits to pay the rainmakers by increasing their associate leverage.

Devolution can be self-perpetuating. Hiring more associates makes it harder for firms to provide the training and mentoring necessary to back their reputational bond. Lateral hiring and geographic dispersion complicate firms' ability to maintain a strong culture of trust and cooperation.

Big Law's devolution likely will not be limited to specific practice areas. The Henderson-Bierman study suggests that the firms that are in the best position to survive have more lucrative specialties, which the authors identify as capital markets, private equity, white collar crime, and securities enforcement.⁸⁸ What they call "commodity" legal areas, including regulatory compliance, labor, trusts and real estate, face the most stress. As law firms attempt to capitalize on these trends by moving toward more lucrative areas, Henderson & Bierman predict that Big Law's financial stability will be undermined by overcapacity.⁸⁹ Indeed, the meltdown that followed the end of the study period in 2007 struck at some of the formerly lucrative areas such as capital markets and private equity.

Devolution might be reflected in a variety of business structures. One approach is the "vertical" firm exemplified by Marc Dreier's operation, which collapsed in late 2008 amid a spectacular fraud. This is the purely star-driven firm based entirely on associate leverage. Dreier operated as a sole proprietorship, dispensing with Big Law's pretense of

⁸⁷ See Henderson & Bierman, *supra* note 17.

⁸⁸ The phenomenon of chasing after hot practice areas is inconsistent with the argument that Big Law best insulates itself from risk by diversifying. See *supra* text accompanying note 12.

⁸⁹ *Id.*

a “firm” structure.⁹⁰ The firm’s other lawyers were nominally employees who received incentive compensation but not equity shares. Indeed, they were more office-sharers than employees or partners. It is not clear if the firm generated any profits at the entity level distinct from Dreier and the individual lawyers, or why clients would pay a premium for a Dreier lawyer over what the client would pay for the lawyer as a sole practitioner.

Another path to devolution is the “horizontal” all-partner firm with no clear leader. Such a firm could engage in monitoring and quality control consistent with the traditional equal-partner model of the law firm and dispense with the potential disintegrating effects of associate leverage.⁹¹ Some firms even eliminate bricks-and-mortar offices.⁹² Although these firms may have cost advantages for clients as compared with large law firms, the lower costs appear to result from lower, or no, profits at the firm level.

One example of the horizontal approach is Taylor English Duma in Atlanta. Since its founding in April, 2005 by four Big Law lawyers (two partners and two associates), the firm has grown to 75 lawyers in several practice areas.⁹³ One of the founding partners, Marc Taylor, says that the firm accomplished this through cheaper office space, using technology to reduce staff, paying both partners and associates based on productivity as measured by hours worked and productivity, and reducing fees. The firm financed its growth from operating profits rather than through bank debt. The firm consists mostly of experienced lawyers with substantial reputations rather than the steep Big Law labor pyramid.⁹⁴

The devolution of law firms recognizes that large law firms that do not conform to the traditional Cravath-type reputational capital business model cannot generate significant profits at the firm level and become aggregations of individual lawyers. Although only relatively few large firms have died, the signs of stress are more evident in the shrinkage of large firms, and in the rise of non-firm aggregations of lawyers.

⁹⁰ See Larry E. Ribstein, *Ideoblog*, “Dreier: Economic and legal ramifications” (December 10, 2008), <http://busmovie.typepad.com/ideoblog/2008/12/dreier-economic-and-legal-ramifications.html> (citing and quoting Dreier’s website, which has since been removed).

⁹¹ Henderson & Bierman suggest that these firms could be boutiques with specialized practice areas. However, it is not clear why a diversified firm would not work as well or better as long as the lawyers are not relying on diversification for risk reduction, since firms without strong reputational capital cannot use seniority-based compensation. The Taylor/English example discussed immediately below is an example of a relatively small and “horizontal” but diversified firm.

⁹² See V. Dion Haynes, “Recession Sends Lawyers Home: Firms Trade Brick-and-Mortar Prestige for a Better Business Model,” *Washington Post*, D1 (March 9, 2009), http://www.washingtonpost.com/wp-dyn/content/article/2009/03/08/AR2009030801549_pf.html.

⁹³ See www.taylorenglish.com.

⁹⁴ Email from Marc Taylor, November 14, 2009, on file with author.

G. SUMMARY

The basic question confronting the large law firm is the extent to which these firms produce substantial profits at the firm level, or instead are just aggregations of lawyers or of relatively small networks of lawyers. The theory of the Big Law “firm” is based on the idea that the firm generates reputational capital. However, the conditions for maintaining this capital, particularly including seniority-based compensation and a rigid up or out promotion tournament, exist only in a relatively few top-line firms, such as Cravath. Many more have adopted the Big Law form without the internal structure necessary to maintain it. When big firms try to expand without the support structure they are prone to failure. Big Law recently has been subject to many market pressures that have exposed its structural weakness. The result, not surprisingly, is that large law firms are shrinking or dying and smaller firms that do not attempt to mimic the form of Big Law are rising in their place.

II. LAW’S NEW BUSINESS MODEL

Part I shows that the fundamental problem with Big Law is that most of the largest firms lack a sustainable business model. Reputational capital can support some of the largest firms, but even in those firms it is fragile because the lawyers who generate it are free to leave with their clients. Building a viable business model for Big Law therefore must start with giving the firm rights to productive property. These rights can, in turn, form the basis of financing law firms, rather than forcing them to rely exclusively on bank loans and the partners’ contributions of human and financial capital. In general, this property would involve producing ideas that have value for general groups of customers or clients rather than only for a specific client that can walk out the door with the lawyer.

This Part presents some possible models of what such law firms might look like. Subparts A through E suggest some ways to tweak the Big Law business model, while at the same time showing that these tweaks are unlikely to be enough to save it. We may be headed instead toward the more radical changes beyond Big Law discussed in subparts F and G.

A. MAINTAINING REPUTATIONAL CAPITAL

As we have seen, the reputational bonding model founders on the problem that compensation based on business generation does not motivate lawyers to devote time to firm-building, and equal or seniority-based compensation that rewards firm-building is difficult to sustain as long as lawyers can leave and take their clients with them. Law firms might close the exits and encourage more loyalty if they could enter into strong non-competition agreements that effectively bind lawyers to firms. However, as discussed below in Part III, strong non-competition agreements are not enforceable under legal ethics rules. These rules, in effect, encourage lawyers’ loyalty to individual clients rather than to the firm.

Even apart from ethical rules, reputational capital is unlikely to be a dominant business model for large firms. The current market environment makes it very difficult to

bind lawyers and clients to firms. Lawyers therefore likely would hesitate before committing themselves to traditional law firms through strong and enforceable non-competition agreements. Big Law needs a stronger property model to justify such a commitment. The following subparts suggest some possible alternatives.

B. LEGAL PRODUCTS

The traditional model of legal practice privileges representation of individual clients over other ways of delivering legal knowledge and law-related products that could provide better value to clients. Legal knowledge can be packaged and sold as standardized products. Law-trained people obviously would be involved in production, but they would be earning money in a radically different way from today's hourly billing lawyers. However, the following subsections show that there are significant impediments to this model, including the lack of formal intellectual property protection for legal products.

1. Publications

Firms that provide legal advice and other legal services could leverage their expertise by publishing legal analyses, contracts, standard forms, software, codes and other law-related materials. Some of these products can be copyrighted, which would give the firm clear property rights in the works. However, the works may not be protected if they are published as pleadings, laws or public codes because of the public policy favoring dissemination of law.⁹⁵ Nor are the underlying ideas (such as a takeover defense) subject to copyright protection, though as discussed below they may be protected by patent or trademark laws. Law firms therefore might not get much payoff apart from reputational or branding effects from the kinds of publications they could produce.

2. Patents

Legal ideas may be embodied in products such as tax shelters or takeover defenses that are carefully designed and tweaked to accomplish particular business objectives within a complex legal framework. Legal product designers need to combine legal, technical and business expertise.

The key question regarding these products is whether and how their producers can capture the value they create for the users, given that the benefits extend beyond specific clients who can be billed for time. The history of the poison pill, one of the most important legal inventions of the last twenty years, illuminates the problems inherent in internalizing the benefits of such products.⁹⁶ The pill was developed by an entrepreneurial law firm, Wachtell, Lipton, working for a number of clients. Once litigation established the pill's effectiveness, the pill benefited hundreds of large

⁹⁵ See Bruce H. Kobayashi & Larry E. Ribstein, *Class Action Lawyers as Lawmakers*, 46 ARIZ. L. REV. 733 (2004). With respect to the complications involved in copyrighting contracts, see Kenneth A. Adams, *Copyright and the Contract Drafter*, New York Law Journal (August 23, 2006) at ___.

⁹⁶ See Michael J. Powell, *Professional Innovation: Corporate Lawyers and Private Lawmaking*, 18 L. & SOC. INQUIRY 423 (1993) (providing a detailed history of the pill).

corporations advised by many different law firms. Although Wachtell's becoming a dominant advisor on takeover defenses demonstrates that law firms can internalize the benefits of innovating legal products even without formal intellectual property rights protection, it is not clear when the necessary conditions exist. Martin Lipton could offer the pill to clients bundled with his own general high level advice for corporate managers. Thus, even if clients could get any corporate law firm to draft a pill, many would prefer to buy the pill plus related advice from Wachtell. Lipton's ability to capture the pill's benefits gave him an incentive to serve as its public advocate and to produce a scholarly rationale for strong takeover defenses within a theory of the corporation. However, lawyers generally may be unwilling to develop legal products that have a higher risk of invalidity and lower potential payoff to the creator. Thus, the availability of formal intellectual property protection may determine the extent to which these products are developed.

It is not clear whether and how much patent protection is available to "business methods" such as poison pills and tax shelters.⁹⁷ *State St. Bank & Trust Co. v. Signature Fin. Group*,⁹⁸ held that an investment algorithm that created a "useful, concrete and tangible result"⁹⁹ was patentable. This case opened the door to patents for such non-physical inventions as tax shelters and e-commerce innovations. However, the Supreme Court is currently reviewing the denial of a patent for a mechanism for hedging commodities trading risk.¹⁰⁰ The Court's decision in this case could signal the extent to which legal devices such as poison pills can be patented.

Law firms also might get trademark protection for their products. Indeed, at least one legal product, the "Stock Option Grantor Retained Annuity Trust," or SOGRAT, was both successfully patented¹⁰¹ and trademarked.¹⁰² However, if the product is not copyrighted or patented, a trademark would not prevent another firm from selling the same device as its own product.¹⁰³

⁹⁷ See Dan L. Burk & Brett H. McDonnell, *Patents, Tax Shelters, and the Firm*, 26 VA. TAX. REV. 981 (2007); Richard S. Gruner, *When Worlds Collide: Tax Planning Method Patents Meet Tax Practice to Make Attorneys the Latest Patent Infringers*, 2008 U. Ill. J. L. Tech. & Pol. 107.

⁹⁸ 149 F.3d 1368 (Fed.Cir.1998).

⁹⁹ *Id.* At 1373.

¹⁰⁰ *In re Bilski*, 545 F.3d 943 (Fed. Cir. 2008).

¹⁰¹ See *Patents on Tax-Related Ideas Stir Worry*, Wall St. J., March 14, 2007, <http://online.wsj.com/article/SB117383751682136325.html>.

¹⁰² See PTO Registration No. 2507943, November 13, 2001 (covering use on "Computer software and instruction manuals sold as a unit for use in estate planning, tax planning, trust services, trust planning, wealth transfer planning, charitable gifting, charitable gift planning, and employee benefit planning"); PTO Registration No. 2486079, September 4, 2001 (for "services to others in the fields of estate planning, wealth transfer planning, charitable gifting, and charitable gift planning; providing information in the field of estate planning by means of a global computer network").

¹⁰³ See *Dastar Corp. v. Twentieth Century Fox Film Corp.*, 539 U.S. 23 (2003) (holding that a firm selling as its own product non-copyrighted work originally produced by another party did not violate the Lanham Act).

3. Other litigation and transactional products

Legal advice in litigation may be quite costly. At the same time, some types of claims are very similar across plaintiffs and defendants. Also, several law firms might be involved in a single class action. These circumstances present opportunities for profiting from standardized products.

One potential type of litigation product is a class action complaint. Firms specializing in class action litigation may devote substantial resources to producing a given complaints. Firms theoretically could invest in creating many complaints in multiple cases. As with the other potential approaches discussed above, the firm would not be working for a particular client, but rather making a product for a market of class action plaintiffs seeking fees from being named lead counsel. However, since the firm probably cannot copyright its complaint or get recovery for misappropriation,¹⁰⁴ it is not clear how it can get paid for its drafting other than being named lead counsel.

Some types of legal work particularly lend themselves to standardization and therefore packaging into products. Firms can sell kits for prosecuting or defending claims involving certain types of products.¹⁰⁵ Electronic documents and algorithms can help lawyers find documents with particular types of information produced in discovery.¹⁰⁶ Lawyers can use programs to automate contract production.¹⁰⁷ They can also buy and sell expertise in designing the templates and other mechanisms used for automated contract production.¹⁰⁸

It is not clear how law firms can capture the profits from creating and selling these products. Law firms are structured to render tailored advice to individual clients. They may sell forms and templates as part of their services to individual clients or make them available as a way or generating business,¹⁰⁹ but they are not equipped to profit

¹⁰⁴ See Kobayashi & Ribstein, *supra* note 95 (suggesting the desirability of enabling firms to internalize the benefits of skillful drafting through a share of the fees).

¹⁰⁵ For articles referring to tort lawyers' creation and sale of litigation kits from discovered material, see Victor E. Schwartz & Leah Lorber, *Letter to the Trial Judges of America: Help the True Victims of Silica Injuries and Avoid Another Litigation Crisis*, 28 AM. J. TRIAL ADVOC. 295 (2004-2005); Lawyers for Civil Justice Task Force on Protective Orders, *Court-Approved Confidentiality Orders: Why They Are Needed*, 57 DEF. COUNSEL J. 89 (1990).

¹⁰⁶ See Lon A. Berk, *Some Logical Limits Of E-Discovery*, 12 SMU SCI. & TECH. L. REV. 1 (2008).

¹⁰⁷ A leading product is ContractExpress DealBuilder, which enables firms to design templates to automate the contract production process. See <http://www.business-integrity.com/products/contractexpressdealbuilder/default.html>. The "eXtensible Markup Language" also can be used to create contracts. See Lawrence A. Cunningham, *Language, Deals, And Standards: The Future of XML Contracts*, 84 Wash. U. L. Rev. 313 (2006).

¹⁰⁸ A prominent expert in contract writing and design is Kenneth A. Adams, who has a book (*Manual of Style for Contract Drafting*, Second Edition), as well as a website and consulting business (<http://www.adamsdrafting.com/>).

¹⁰⁹ This is apparently the strategy of Wilson Sonsini Goodrich & Rosati in giving away its "Term

from the economies of scale of developing inventories of forms and other products for a mass market. Law firms theoretically could bring software designers and salespeople on board, software firms already have a head start in that direction. However, professional ethics rules currently bar law firms from adopting the structural elements necessary to retool as intellectual property firms, including non-lawyer equity capital and non-competition agreements. The prospect of standardization therefore may more a threat than an opportunity to Big Law, since it could squeeze some of the profit from transactional work and litigation without letting law firms profit from the new tools.

C. RESEARCH AND DEVELOPMENT

Big Law might provide research and development on specific types of business transactions. This subpart analyzes the current constraints on law firms' performing this role, and the broader implications of these constraints.

George Triantis has argued that law firms could build on their comparative advantage over other types of professionals regarding litigation to bridge their transactional and litigation work by planning transactions in light of expected litigation.¹¹⁰ This insight points toward a potential new Big Law business model: developing information, background, drafting and litigation strategies on issues that arise repeatedly in the firm's work. The firms could then use this information to render high-value legal advice in their areas of expertise at prices competitive with less expert firms. Although the firms would not have intellectual property rights in documents that are publicly filed or disclosed in litigation, other information could remain proprietary to the extent that it is used solely for advising clients or anticipating problems in drafting client-specific documents.

Law firms' ability to profit from this type of work assumes a basic change from the traditional Big Law business model of serving as a full service center for the diverse needs of their large corporate clients. Large law firms have developed multiple departments, such as corporate, litigation, antitrust, to serve these needs as they arise. Under the proposed approach, large law firms would continue to do both transactional and litigation work, since as discussed above their comparative advantage lies in bridging this work. However, some firms could specialize in particular types of transactions or litigation. This would enable firms to capitalize on investments in issues that the firm expects to crop up repeatedly in its practice because it is both specialized and has a large share of the market for this type of advice.

Innovative and integrated transaction planning lets Big Law recapture some turf from its competitors. Small boutique law firms will not have the resources to move beyond specific cases to broad transaction planning. Even the largest clients with the biggest in-house legal departments are unlikely to incur the costs of developing research whose benefits are shared by other firms unless the research concerns issues that are central to the client's business.

Sheet Generator." See <http://www.wsgl.com/wsgl/Display.aspx?SectionName=practice/termsheet.htm>.

¹¹⁰ See "Triantis, taking Goldston chair, looks at emerging threats to transactional legal practice," <http://www.law.harvard.edu/news/spotlight/business-law/triantis-chair-lecture.html>.

One way large law firms could contribute to transaction planning is by developing and maintaining operating agreements or contract provisions for specific types of businesses. The open-ended business association standard forms that legislatures have enacted do not deal at all with many issues, and deal with others in ways that are unsuitable for many firms. The number of different statutory standard forms that legislatures can provide, and therefore their suitability for specific situations and clients, is limited by the costs of developing the forms and the need for interpretive materials for each form.¹¹¹ Accordingly, there are only a few business association standard forms, most of which are designed for very small and simple firms that do little or no customized drafting. This forces more complex firms to incur the costs of crafting detailed agreements or being left to unsuitable default rules. Large law firms can use their expertise in both planning and litigating transactions to develop and continue to evolve customized form agreements that fill this gap. They also could build on this expertise by maintaining computerized databases of contracts, doing in-depth research on contracts and transactions, and engaging economists and other analysts to help anticipate future litigation and structure transactions to minimize litigation costs. In short, a restructured version of Big Law could significantly augment what both lawyers and legislatures currently can do in drafting statutes and form agreements.

The economic potential for law firm research and development raises the question of why law firms have not already moved in this direction. The answer may be that the current model of law firms, backed by professional ethics rules, is client-specific work and billing. It does not readily lend itself to profiting from research and development that benefits classes of cases and clients.

Law firms may be able to protect their work as trade secrets if the information “derives independent economic value, actual or potential, from not being generally known to, and not being readily ascertainable by proper means by, other persons” and is “the subject of efforts that are reasonable under the circumstances to maintain its secrecy.”¹¹² It is not clear how these tests would be met for legal research. In this case, the work product must be at least partially disclosed whenever the law firm uses it in a case. Moreover, lawyers working on the research cannot be bound to the firm by broad non-competition agreements,¹¹³ and the firm may not even be able to bind lawyers by confidentiality agreements to the extent that this would disable their representation of future clients.¹¹⁴ These restrictions on contracting may not only affect whether the

¹¹¹ For discussions of the constraints on developing standard forms see Larry E. Ribstein, *Making Sense of Entity Rationalization*, 58 BUS. LAW. 1023 (2003); Larry E. Ribstein, *Statutory Forms for Closely Held Firms: Theories and Evidence from LLCs*, 73 Wash. U. L. Q. 369 (1995).

¹¹² See Unif. Trade Secrets Act § 1(4). For an analysis of the prerequisites of trade secret protection see Jeanne C. Fromer, *Trade Secrecy in Willy Wonka's Chocolate Factory*, THE LAW AND THEORY OF TRADE SECRECY: A HANDBOOK OF CONTEMPORARY RESEARCH, Rochelle C. Dreyfuss, Katherine J. Strandburg, eds. (Edward Elgar Publishing, 2010), Fordham Law Legal Studies Research Paper No. 1430463, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1430463.

¹¹³ See *infra* subpart III.A.2.

¹¹⁴ See Ethics Committee of the Illinois State Bar Association (ISBA). In ISBA Comm. on Professional Ethics Op. 00-01, 10/00; Shop Talk, *Confidentiality Agreements For Tax-Savings Products--*

research is deemed to be a trade secret but also reduce the firm's ability to protect property that is not a trade secret.

Law firms' inability to invest in research and development could help solve some persistent contracting puzzles. For example, commentators have wondered why some types of contract provisions such as boilerplate in bond agreements have been surprisingly "sticky" in response to events that might have been expected to produce contract changes.¹¹⁵ An important study of choice of form by venture capital portfolio firms revealed that these firms incorporate despite apparent tax disadvantages of the corporate form.¹¹⁶ The persistence of this phenomenon is even more puzzling today given new standard forms that seemingly provide a better combination of liability protection and flow-through tax treatment than does the corporate form. Litigation involving fiduciary waivers under the freedom-of-contract provisions in the Delaware unincorporated business entity statutes reveals drafting errors that have kept firms from taking full advantage of their freedom.¹¹⁷

This literature suggesting that contracting parties cannot internalize the benefits of developing standard forms leaves open the question of why law firms could not perform this internalization function. In all of the above situations, law firms potentially could develop the necessary contractual devices if they could acquire intellectual property rights in their work.

Gulati & Scott's detailed analysis of a particular type of provision in sovereign bond contracts¹¹⁸ illustrates how constraints on law firm organization may be inhibiting the creation of a Big Law research-and-development business model. They discuss the fallout from the *Elliott* case,¹¹⁹ in which a hedge fund won a preliminary injunction by arguing that a so-called "*pari passu* clause" in the bond contract barred Peru from making payments to the holders of the restructured bonds without making proportional payments to the plaintiff. The court applied an equal treatment rule previously believed to be

Are They Unethical?, 94 J. Tax'n 61, 2001 WL 999 (2001). The Illinois Ethics Committee focused on Illinois Rule of Professional Conduct 1.7(b) relating to limitation of representation of future clients. It also discussed Rule 5.6 relating to restricting a lawyer's right to practice and Rule 5.5(b) as to whether the confidentiality agreement assisted an accounting firm engaged in the unauthorized practice of law.

¹¹⁵ See Marcel Kahan & Michael Klausner, *Standardization and Innovation in Corporate Contracting (or "The Economics of Boilerplate")*, 83 VA. L. REV. 713 (1997).

¹¹⁶ See Joseph Bankman, *The Structure of Silicon Valley Start-Ups*, 41 UCLA L. REV. 1737 (1994). See also, Victor Fleischer, *The Rational Exuberance of Structuring Venture Capital Start-Ups*, 57 TAX. L. REV. 137 (2004) (explaining venture capitalists' reluctance to use these forms in part based on insecurity of using untested formats).

¹¹⁷ See Larry E. Ribstein, *The Uncorporation and Corporate Indeterminacy*, 2009 Illinois Law Review 131 (discussing cases in which fiduciary duty waivers were held not to apply to conduct in question).

¹¹⁸ See Mitu Gulati & Robert Scott, *Sticky Contracts (or Why Don't Law Firms Have R&D Departments?)* (draft, February 16, 2009).

¹¹⁹ *Elliott Associates No. 2000QR92* (Court of Appeals of Brussels, 8th Chamber, September 26, 2000)

applicable only during liquidation to a restructuring without a liquidation event. The authors found that this unprecedented case, despite its significant consequences for many bondholders, did not result in changes to the contracts containing the disputed clause. The authors interviewed lawyers seeking to understand this contractual “stickiness.” The lawyers cited several explanations for the failure to change the clause, including concern about sending a negative signal regarding interpretation of the superseded language; a desire to preserve *pari passu* as a way out of the contract; client cost-consciousness and desire to get the deal done without extensive negotiations; anti-innovation norms; and uncertainty as to how to fix the clauses. The authors note problems with many of these explanations.

One explanation for the stickiness of *pari passu* that seems especially promising, as suggested by the subtitle of Gulati & Scott’s article is law firms’ lack of incentive to invest in research and development. This explanation seems to lurk at the edges of some of the lawyers’ explanations, including cost-consciousness and resistance to innovation. Although developing deeper knowledge concerning the origins of the *pari passu* problem and more analysis of how to solve the problem might have been worthwhile, neither individual clients nor their lawyers had the incentive to bear the costs of this work without the ability to capitalize on its benefits.

Law firms are impeded from investing in this information in part because the information is not directly or indirectly protectable intellectual property. One lawyer explained that “[i]t would be easy for others to copy any new clause we came up with . . . the reputations that matter are for getting the deals done . . . not [for] knowing the historical origins of some obscure contract provision.”¹²⁰ Also, the information’s value is closely bound to expertise that lawyers can take with them when they leave the firm. Ethical rules discussed below prevent law firms from protecting this information in the traditional way through non-competition and confidentiality agreements.

If law firms could protect their property rights in research and development, the firms might be able to finance this work by offering investors a return based on the firm’s extra income from its in-depth expertise over and above the value of lawyers’ services to individual clients. The firms also might hire and give ownership interests to non-lawyer experts, such as psychologists, economists and historians, or to lawyers and law consultants dedicated to building in-depth knowledge and analysis rather than just work for specific clients.

This explanation of law firms’ potential but constrained role in solving contracting problems through research and development could fill gaps in Gulati & Scott’s interviews and analysis. For example, they note that Lee Buchheit of Cleary Gottlieb and Phillip Wood of Allen & Overy did valuable extra in-depth work on the *pari passu* problem. They describe Buchheit as “sui generis,” a “maverick [who] works outside the firm’s traditional structures, spending significant amounts [of] non billable time advising governments and teaching law school classes, often doing his own research in remote archives.” Yet Cleary paid this “maverick” for his work, and this investment

¹²⁰ See Gulati & Scott at ____.

evidently paid off when Buchheit took the lead in the *pari passu* litigation crafting arguments and strategy. Gulati & Scott note that

[t]hese individuals do not fit the model of relentless accumulators of billable hours and rarely do they have stables of clients. But they are the closest we see to R&D departments in law firms. One junior associate described this as “the wise man model”.

Gulati & Scott also note that litigators often do the extra work that transactional lawyers do not, and that it was a vulture investor fund that was willing to do the costly and risky spadework that led to its substantial payoff on the *pari passu* issue. If there is a reward for making these arguments, it would seem there is comparable reward for responding to them by redrafting documents, and for anticipating them and preventing cases like *Elliott* from threatening the security of bond agreements.

Understanding law firm structure could help tie these loose ends in explaining sticky sovereign bond provisions. One reason why some lawyers make the investments that transactional firms typically do not is that they can capture the benefits of their extra work through the reputations they have developed by specializing on a particular type of contract. Since the lawyer owns his reputation and its associated benefits, he does not have to worry about his colleagues defecting with the property as in the typical law firm situation. The lawyer knows he will get paid either from his current firm or from some future firm willing to invest in his book of business. Even if Buchheit could not expect a payoff from enhancing his own reputation and clientele, he likely brought prestige and therefore clients to Cleary. Under Big Law’s traditional reputational capital model the firm’s lockstep seniority compensation system rewards lawyers for building the firm rather than just their specific clienteles. Cleary, in fact, has such a compensation system.¹²¹ This suggests a possible bridge between the traditional Big Law model and a reputational capital model.

Elliott Associates, for its part, was willing to make a speculative investment in gathering the relevant information and instigating the litigation because it would capture any reward, and because its investors likely were better diversified and therefore had lower risk-bearing costs than typical law partners.

In short, there are clearly potential gains from extending law firms’ ability to capitalize on in-depth investments in research and development by enabling them to establish property rights in the products of the research and to raise capital from non-lawyer investors. This indicates the potential for alternative law firm business models that could earn significant benefits once ethical rules are relaxed.

¹²¹ See Cleary Gottlieb, “Firm Culture,” <http://www.cgsh.com/firmculture/> (“Cleary Gottlieb operates on a seniority-based compensation system not only for associates, but also for partners, with the principle that each partner should contribute equally to the firm’s success”).

D. FINANCING THE NEW LAW FIRM

Law firms are owned solely by lawyers. Although a law firm may employ other professionals, and non-law firms may employ law-trained people, a firm that has equity owners who are not lawyers may not engage in the practice of law. As discussed further below,¹²² this restriction is intended to ensure that those who control the firm share legal professional norms. Until recently, this restriction has not been much of a problem because it has not been clear precisely why anybody other than lawyers would want to own a law firm. This seems to be reinforced by recent trends. If, as discussed in Part I, law firms are becoming more like aggregates of lawyers and less like firms, they would seem to have little need for outside capital and little ability to attract such investments. However, this Part shows that there are business rationales for outside financing of law firms, including in public securities markets. It also discusses the governance structure of law firms with outside equity. Finally, it considers alternative financing structures, specifically asset-based financing and franchising, which could provide some of the advantages of outside ownership of law firms while arguably operating with the existing regulatory structure.

1. The demand for outside capital

Outside capital has several apparent advantages even for law firms in their current form. First, it can reduce risk-bearing costs compared to putting the entire financing burden on lawyer-owners who also invest their human capital in the firm. Outside financing would enable lawyers to diversify their risk by selling some of their investments in the firm to outside owners.

Second, law firms could use outside financing to pay the significant costs of running a law practice, including for office space, sophisticated technology, salaries for staff and associates, and partner draws for living expenses. Law firms suffer from a mismatch of revenues and expenses, since their bills come due regularly while work for clients may be billed and paid irregularly. Even a basically viable firm therefore may face a liquidity crunch when its bank loans come due and its only assets are accounts receivable and pending cases.¹²³ As discussed above, loan defaults triggered the demise of several large law firms.¹²⁴

Third, outside financing theoretically could relieve the financial burdens associated with lawyer departures. Under current professional rules, lawyers can cash out only by a sale to their remaining partners or, under certain conditions, to other lawyers.¹²⁵ Lawyers presumably would insist on some cash-out right as a condition of entering into a law firm to avoid freezing their capital in the firm exposed to potential majority oppression. The demand for exit rights has increased with the mobility of law partners

¹²² See *infra* subpart III.A.1.

¹²³ See Morgan, *supra* note 25 (discussing law firms' use of lines of credit and other leverage).

¹²⁴ See *supra* subpart I.E.1.

¹²⁵ See ABA Model Rules of Professional Conduct, Rule 1.17.

discussed in Part I. At the same time, the firm's need to come up with cash to pay off exiting partners imposes a significant financial strain on already heavily leveraged lawyer-financed firms. An equity cushion theoretically could relieve this stress.

Fourth, the capital constraint affects how the firm compensates its lawyers. Although the Big Law promotion tournament provides a way to determine which associates should be given a chance for a long-term career with the firm,¹²⁶ making the prize a partnership interest may not always be the best strategy for the firm or its associates. Relying on the tournament forces law firms to keep adding partners, which in turn forces them to hire more associates to generate the profits to pay the partners. This can be viewed as a kind of "Ponzi scheme" that makes money by attracting more investors.¹²⁷ As discussed in Part I, the tournament model has broken down with the rest of the traditional Big Law model. Outside financing would enable law firms to replace promotions to partner with cash or stock compensation comparable to those paid in conventional firms.¹²⁸

2. Supply of outside capital

The previous section's discussion of potential advantages of outside capital for law firms raises the question of whether outsiders would want to provide the cash. Law firms might seem to be attractive business propositions because they typically generate significant income streams in good times and bad. However, law firms are essentially worker cooperatives whose income is generated by highly mobile employees. Thus, unless law firms can pursue other business models that are currently constrained by professional ethics rules, they can offer outside investors little to invest in other than faith that they will be able to hold onto their rainmakers. Big Law's demand for outside financing of law firms is actually based on the breakdown of Big Law's traditional business model, which has left large firms unable to rely on bank debt. Outside financing requires replacing this traditional model with a more viable model, such as those discussed above in this Part, which would be able to attract outside investment.

3. Publicly traded firms

If law firms could sell interests to outside investors, there is an additional question whether these interests could or should be publicly traded. This previously unimaginable step has been taken with the successful public offering by Slater & Gordon in

¹²⁶ See *supra* note 15 and accompanying text.

¹²⁷ See Morgan, *supra* note 25 at 109.

¹²⁸ See M.K. Berkowitz & Y. Kotowitz, *Promotions as Work Incentives*, 31 ECON. INQUIRY 342 (1993).

Australia,¹²⁹ which was enabled by the 2001 deregulation of non-lawyer ownership in Australia.¹³⁰ Similar developments are occurring in the UK.¹³¹

Public sale of law firm shares has many of the same business justifications as any firm's sale of outside equity, including providing cash for investing in business opportunities, enhancing lawyers' ability to diversify investment risk and increasing the marketability and value of lawyers' shares by having them traded in efficient securities markets. Similar considerations helped motivate the public offering by the private equity firm Blackstone in 2007.¹³² Like law firms, Blackstone was selling interests in the partners' expertise. As with sale of outside equity generally, public outside investors would insist on a reasonable prospect of earnings growth from firm-level assets rather than simply getting a slice of the firm's existing revenue stream. In Slater & Gordon's case, the business model was consolidation of a nationwide network of storefront offices and financing future litigation.¹³³

If the business case for public financing of law firms becomes compelling, policymakers will have to confront the arguments for prohibiting it. As noted above and discussed more fully below, the concern is that lawyers will become beholden to outside owners, thereby threatening professional norms. Even if this concern is legitimate, it might be addressed by specific regulation rather than by wholly prohibiting outside capital investments.

4. Governing the outside-owned firm

Law firms with outside investors would present special governance issues. The investors need ways to control agency costs arising out of the exercise of control by the firm's lawyers and managers. At the same time, the lawyers who invest their human capital in the firm and will be subject to ethical obligations need to hold onto critical management power. Indeed, regulators are likely to limit control by outside financiers who do not share professional norms.

¹²⁹ For discussion of this offering and some of the relevant issues, see Bruce MacEwen, Milton C. Regan, Jr., & Larry E. Ribstein, *Law Firms, Ethics, and Equity Capital: A Conversation*, 21 GEO. J. LEG. ETH. 61 (2007); Larry E. Ribstein, *Want to Own a Law Firm?* <http://www.american.com/archive/2007/may-0507/want-to-own-a-law-firm> (May 30, 2007).

¹³⁰ For the current version of the law, see New South Wales Legal Profession Act 2004 No 112, Chapter 2, Part 2.6, ¶Division 2 <http://www.legislation.nsw.gov.au/fragview/inforce/act+112+2004+ch.2-pt.2.6-div.2+0+N> (permitting incorporated legal practices).

¹³¹ See UK Legal Services Act 2007 (October 30, 2007), http://www.opsi.gov.uk/acts/acts2007/ukpga_20070029_en_1 (permitting rules allowing alternative business structures, including publicly traded firms).

¹³² See Larry E. Ribstein, *Going Privlic*, American.com, March 27, 2007, <http://www.american.com/archive/2007/march-0307/going-privlic>.

¹³³ See Slater & Gordon Limited Prospectus, April 13, 2007. Litigation could be an independent basis of financing, as discussed below in *infra* section II.G.2.

In general, there is no reason to think that lawyers' duties to clients should make managing law firms fundamentally different from managing other types of firms. Firms cannot survive in the long run unless they cater to their customers, including by building their reputations for long-term fair dealing.¹³⁴ The main question about outside-owned law firms concerns lawyers' professional and social obligations other than to clients to exercise their independent judgment, including by monitoring clients' conduct. Corporate clients raise a related concern about the lawyer's responsibility to the "entity" or the owners rather than to particular managers. These obligations have become important in the wake of corporate scandals and regulation giving lawyers a special gatekeeper role.¹³⁵

The firm's governance structure accordingly has to be designed to minimize agency costs while preserving the lawyers' basic control over the firm's governance and ensuring that law firms honor their social obligations. The control part can be taken care of by incorporating the firm and giving the lawyers control shares analogous to the founders' shares of Google and media firms such as the companies that own the Washington Post and the New York Times. However, entrenching managers potentially increases agency costs. Corporate-type monitoring devices theoretically could be adapted to balance agency costs against law firms' social obligations. For example, the firm might have independent directors who represent the interests of the firm as a whole, including shareholders, clients and society or managers' fiduciary duties could be qualified to expressly permit them to sacrifice owners' interests for those of clients or society.¹³⁶ However, it may not be clear how these modified duties would differ from the significant leeway allowed unselfish managers under the business judgment rule.¹³⁷

A more fundamental problem with the corporate structure is the loss of owner commitment to the firm's welfare that is ensured by partnership-type equal management and financial sharing. Indeed, some commentators have blamed the 2008-2009 financial meltdown in part on the incorporation of investment banking partnerships in the 1990s.¹³⁸

¹³⁴ See Edward S. Adams & John H. Matheson, *Law Firms on the Big Board?: A Proposal for Nonlawyer Investment in Law Firms*, 86 Cal. L. Rev. 1 (1998) (discussing market and legal constraints that would cause non-lawyer-owned firms to act in clients' interests).

¹³⁵ See Sarbanes-Oxley Act of 2002, §307 (imposing ethical obligations on lawyers to report client wrongdoing); Larry E. Ribstein, *Limited Liability of Professional Firms after Enron*, 29 J. CORP. L. 427 (2004).

¹³⁶ For example, Australia's Slater & Gordon clearly makes duties to owners subject to lawyers' duties to their clients. See Slater & Gordon Prospectus, *supra* note 133, Section 1.1 (noting that "[t]he Constitution of the Company provides that the Directors, who must always include at least one lawyer, must give primacy to the duties a lawyer owes first to the Court and secondly to clients").

¹³⁷ See Larry E. Ribstein, *Accountability and Responsibility in Corporate Governance*, 81 N.D. Law REV. 1431 (2006).

¹³⁸ See Steven M. Davidoff, *A Partnership Solution for Investment Banks*, *N.Y. Times Dealbook Blog*, Aug. 20, 2008, <http://dealbook.blogs.nytimes.com/2008/08/20/a-partnership-solution-for-investment-banks/> (noting that firm that Goldman Sachs, which remained most partnership-like, best avoided problems with subprime); James K. Glassman & William T. Nolan, *Bankers Need More Skin in the Game*, *Wall St. J.*, Feb. 25, 2009, at A15, <http://online.wsj.com/article/SB123552702523065837.html>; Michael Lewis, *The*

Outside-owned law firms can avoid this pitfall of incorporation while departing from the traditional partnership form by adopting a modified version of law firms' current unincorporated business forms.¹³⁹ For example, they might organize as manager-managed limited liability companies (LLCs) or limited partnerships with the lawyers as the general partners or managing members and the outside capitalists as limited partners or non-managing members. A particular advantage of unincorporated business forms is that they substitute distributions and high-powered partner-type incentive compensation for corporate-type monitoring devices like fiduciary duties, shareholder voting and independent directors.¹⁴⁰ This discipline could give outside owners some protection against agency costs while locking control in the professionals. This structure's specific advantage for law firms is that the governance documents need not prescribe managers' precise obligation to maximize the value of the outside owners' interests. Instead, the outside owners would resemble creditors in the sense that the firm decides on the extent to which profits will be distributed to investors and otherwise gives managers full discretion to run the business.

Unincorporated structures are helpful for the additional reason that they can facilitate contracting better than the more rigid corporate form.¹⁴¹ This flexibility has encouraged the development of a variety of non-corporate standard business forms that could serve law firms' needs. For example, unincorporated law firms might address the contracting problems inherent in balancing duties to various constituencies by forming a so-called "low-profit limited liability company," or L3C. The Vermont statute requires the L3C, among other things, not to have a "significant purpose" of producing income or property appreciation.¹⁴² This type of standard form could serve as the basis of case law and professional advice that helps delineate managers' duties and applies them to particular fact situations. These standard forms therefore could combine some measure of predictability with the inherent contracting flexibility of non-corporate forms.

The problem with unincorporated governance is that, while it might suit the current model of the law firm, it might not be as well designed for the new business models discussed above in this Part. Although law firms now distribute all or most of their profits to their owners, law businesses of the future may more closely resemble typical entrepreneurial firms that need the flexibility to reinvest earnings in order to

*End, Portfolio, Nov. 11, 2009, <http://www.portfolio.com/news-markets/national-news/portfolio/2008/11/11/The-End-of-Wall-Streets-Boom?>; Caroline Salas & Pierre Paulden, *Eat-What-You-Kill Bond Traders Rise From Wreckage* Mar. 24, 2009, <http://www.bloomberg.com/apps/news?pid=20601109&sid=aTfBlzAvaBoM&refer=news>.*

¹³⁹ For discussions of the analogous application of the unincorporate form to investment banks, see Larry E. Ribstein, *THE RISE OF THE UNCORPORATION*, 239 (2009); Larry E. Ribstein, *The Uncorporation's Domain*, __VILL. L. REV.__ (2010).

¹⁴⁰ See generally, Ribstein, *supra* note 36; Larry E. Ribstein, *Partnership Governance of Large Firms*, 76 U. CHI. L. REV. 289 (2009); Larry E. Ribstein, *The Uncorporation's Domain*, forthcoming Villanova Law Review.

¹⁴¹ See Ribstein, *supra* note 36, §1.D.3 (comparing flexibility of corporations and unincorporations).

¹⁴² See Vt. Code, title 11, ch. 21, § 3001(27); Low Profit Limited Liability Company, http://www.sec.state.vt.us/corps/dobiz/llc/llc_l3c.htm.

develop new lines of business. This may put some pressure on the unincorporated business form, which relies on forcing distributions to control agency costs. Thus, the governance dilemma of the outside-financed firm will be to find some way to meet these multiple demands by melding incorporated with unincorporated business structures.

A final governance issue is concerns the managers of outside-owned law firms. These firms likely will turn to the same types of conventional managers as other firms, including people with experience across service and perhaps other industries.¹⁴³ This would follow the analogous path of technology firms like Google that have hired non-technically-trained top managers. It is not clear that law firm managers need to be lawyers more than technology firm managers need to be technicians. Indeed, law firms' survival may depend on their ability to find professional managers whose thinking is not bound by traditional professional norms. This paper has shown that Big Law's traditional business model has failed and that it has to find another one. Successful legal services firms must have creative professional management capable of looking outside the traditional law firm model.

5. Franchising and joint ventures

So far this section has focused on a single law firm raising capital from outside investors. An alternative model would be for law firms to extend their scale and scope through separately owned offices bound by contract. This model pushes the boundary between firm and non-firm contract.

Franchising is one example of this model. Under this approach, a firm leverages its name by authorizing its use by multiple firms, perhaps in different cities or with different specialties. At the Big Law end of law practice, large law firms can expand into new cities by opening new offices or acquiring existing firms and attaching their names. Another approach is franchising storefront offices to do tax, real estate or similar routine work for individual clients. Instead of the firm's raising money from outside investors to finance the expansion, each branch stands on a separate financial footing and licenses the name brand. The franchise contract specifies the franchisee's duties to maintain the value of the brand and the franchisor's duties to promote the brand. The franchisor's reputation bonds the branches' performance in the sense that any shirking by the outlet can diminish the franchisor's overall brand. The franchisor would develop incentives and provide monitoring to ensure that shirking in branch offices does not hurt the franchisor's reputation. Franchising also offers economies of scale by selling products and using procedures developed by the central organization, and can use the organization's customer base to gather information to develop additional products and procedures.

A basic problem with the franchise approach is that franchisees arguably have even weaker incentives to maintain the firm's reputational capital than the partners in a law firm. Indeed, franchising at the Big Law end of law practice is very similar to law firms' expanding by acquiring and applying their names to firms outside their home base.

¹⁴³ See Elizabeth Chambliss, *New Sources of Managerial Authority in Large Law Firms*, 22 GEO. J. LEGAL ETHICS 63 (2009) (discussing increasing professionalism of law firm management).

As we have seen, this expansion led to many of the firm failures discussed at the end of Part I.

Franchising may be more appropriate for the commodity or storefront end of law practice. In this situation it is easier for the franchisor to monitor performance, than for the high end professional services performed by Big Law. The franchise contract could replace open-ended joint maximization and relatively weak incentives with narrower duties backed by strong enforcement, including the threat of termination of the franchise. Also, franchising of commodity law practice potentially can address information asymmetry between lawyers and consumers who have less ability to evaluate legal services than corporate clients with in-house counsel and repeat dealings with lawyers. However, franchising of legal services has not worked even at the commodity end of legal practice. Jacoby & Myers and Hyatt Legal Services pioneered this approach in the 1970s. The former dissolved and the latter morphed into Hyatt Legal Plans, now owned by MetLife, an employer-sponsored legal services plan. These firms evidently could not find a sufficient niche in the area of standardized, easily monitored, commodity legal services that was left by legal software, the Internet and increased crowding in the legal profession.¹⁴⁴

A second contractual approach to combining law offices is for firms to form joint ventures or other types of cooperative organizations. The firms would operate under their own names and reputations, but contract to assist each other in providing joint services to clients. The joint venture or other cooperative contract will provide for the services the contracting parties must render. As with franchise, a common set of residual claimants who have incentives to maximize the earnings of the overall firm is replaced by contracts specifying the nature of the cooperation. The joint venture or cooperative model would not rely as heavily as the franchising model on monitoring and incentives because each office would be backed by its own reputation. The danger is lies in agency costs between the client and the firm with which the client directly contracts. The firm that maintains the client relationship may have an obligation of independence in recommending the firms that will assist it and a duty to disclose who is doing the work and any connections between the firms. These obligations do the work of the reputational bond of an integrated law firm. However, ethical rules restricting referral fees outside of law firms¹⁴⁵ may inhibit the usefulness of these networks.

¹⁴⁴ See Gillian K. Hadfield, *The Price of Law: How the Market for Lawyers Distorts the Justice System*, 98 MICH. L. REV. 953, 889, n.80 (2000) (noting that “scale has been achieved in the form of chains of small offices which share the benefits of experience concretely in standardized documents and procedures,” but that “[s]tandardization . . . appears to have effectively put these lawyers out of business”); Carl M. Selinger, *The Retention of Limitations on the Out-Of-Court Practice of Law by Independent Paralegals*, 9 Geo. J. Legal Ethics 879, 891-92 (1996) (noting that “there were limits to how little time could be spent with clients. . . . With increased crowding and competition in the legal profession, and increased use of computers by independent lawyers, the interstate legal clinics found that their fees were often higher than those charged by Main Street practitioners”).

¹⁴⁵ See Model Rules of Professional Conduct Rule 5.4.

E. BEYOND LAW FIRMS

So far we have focused on the practice of law by firms that engage only in giving legal advice. However, the sale of legal expertise need not be restricted to this structure. The standard model of the standalone law firm ignores potential synergies between legal advice and other activities which might not be fully realized by arms' length contracts among clients, lawyers and other service-providers. Thus, it may be more efficient for firms to combine legal services with other activities under common ownership, where control may or may not be exercised by lawyers. The relevant firm may be the company seeking the legal advice (i.e., in-house lawyers), consulting or other firms combining multiple disciplines, and retailers who sell law as a commodity along with other products and services.

1. In-house lawyers

As discussed above,¹⁴⁶ legal work is increasingly becoming a job description within another business rather than a distinct business or line of business. This could leave outside lawyers to focus on narrow specialties while corporate employees make more of the increasing number of strategic business judgments that intersect with law. Although corporations are unlikely to move all of their legal work in house, firms' option to "make" rather than "buy" legal advice likely will be a continuing source of cost pressure on the Big Law model.

2. Multidisciplinary firms

There are significant synergies between law practice and other specialties.¹⁴⁷ Many types of experts other than lawyers can contribute to litigation and transactional work, including economists, accountants, financial analysts, business consultants, psychologists, medical doctors, and actuaries. This creates a demand for creation and dissemination of legal knowledge within multidisciplinary firms. Information asymmetry between experts and clients demands reputational bonding for these experts just as for lawyers. Also, the facts that multiple types of expertise can be required for the same transactions and litigation and that clients' needs for the services can arise unpredictably and for short timeframes may make hiring a multidisciplinary firm less costly than hiring the experts separately. Moreover, because the client needs the whole bundle of services and the firm's assurance of quality, the client of a multidisciplinary firm may have a stronger bond to the firm than a Big Law client. Accordingly, multidisciplinary services may provide firm-based property rights that are missing from Big Law, whose clients are subject to walking out the door with individual lawyers.

Multidisciplinary firms do not, however, have to be "law" firms. Legal advice might be added to such large and publicly traded firms as LECG and Accenture, which are already engaged in such law-related services as expert testimony, risk analysis and

¹⁴⁶ See *supra* section I.D.1.

¹⁴⁷ See Gillian Hadfield, *Legal Barriers to Innovation: The Growing Economic Cost of Professional Control Over Corporate Legal Markets*, 60 STAN. L. REV. 102 (2008).

electronic discovery.¹⁴⁸ Also, investment firms might add legal advice and thereby position themselves to offer one-stop deal-making service, which could offer clients advantages in terms of coordination and information-sharing.¹⁴⁹ Lawyers in these firms might share profits with other experts, instead of being the sole profit sharers and hiring the experts for a fixed wage or fee. Legal representation need not be these firms' most important line of business.¹⁵⁰ Even if the firm works on litigation or regulatory compliance, the important expertise may be accounting or business strategy rather than an ability to interpret rules or court decisions.

The problem with this concept of the multidisciplinary firm is that, as discussed below,¹⁵¹ professional rules forbid firms from practicing law in firms with non-lawyer owners. This can be a significant limitation. The firm's value depends on the members being willing to generate expertise that fits the firm's particular combination of disciplines. For example, economists who testify or advise on antitrust cases must be willing to devote themselves to this particular line of work rather than ranging across economics as academic economists might do. Experts who specialize may forego job opportunities and therefore wages, and be vulnerable to opportunism by the firm, for which they would want to be compensated by a share of the firm's profits.¹⁵² Also, non-lawyers as well as lawyers may need to be motivated by ownership interests to increase the firm's value. Prohibitions on non-lawyer ownership of multidisciplinary firms engaged in law practice therefore reduce the potential benefits of combining legal and non-legal services.

3. Retailing law

Law may be just one of several lines of products or services sold directly to consumers. For example, chains like Wal-Mart or Tesco can sell wills and other legal advice along with tax services and eyeglasses. An established retailer can leverage its brand by extending the firm's scope to embrace a different type of service. Unlike the franchise model discussed above, mass retailers can compete with small independent law offices because they have more established reputations and can cross-sell legal and other types of services.

¹⁴⁸ See About LECG, <http://www.lecg.com/about>; Accenture, <http://www.accenture.com/>.

¹⁴⁹ See Larry E. Ribstein, *On My Mind: Lawyers Don't Make Enough*, *Forbes*, October 29, 2007, at 40, <http://www.forbes.com/forbes/2007/1029/040.html> (discussing this business model).

¹⁵⁰ In other words, lawyers are not necessarily the key transaction cost engineers, as argued in Ronald J. Gilson, *Value Creation by Business Lawyers: Legal Skills and Asset Pricing*, 94 *YALE L.J.* 239 (1984). Their historical importance as the "passkeys" of large transactions may be an artifact of licensing and ethical rules discussed rather than of the inherent importance of lawyers' legal expertise and other unique skills.

¹⁵¹ See section III.A.1.

¹⁵² See David D. Haddock, Jonathan R. Macey & Fred S. McChesney, *Property Rights in Assets and Resistance to Tender Offers*, 73 *VA. L. REV.* 701 (1987) (showing how giving corporate managers job protection encourages them to make firm-specific investments of human capital in their firms).

As with multi-disciplinary firms, the problem again is the ethical proscription on non-lawyer-owned firms practicing law. This concern might seem to be more intense in this situation since the owners would be non-professionals who theoretically are more attuned to the employer's bottom line than to the client's interests. However, as discussed above,¹⁵³ firms have a strong profit motives to preserve their reputations for fair and honest dealings with clients and others. Indeed, as noted immediately above, moving law practice to firms that are more economically viable than traditional law firms could strengthen the reputational bonds the firms can offer clients. Instead of having to trust a worker cooperative with a tenuous future or a sole practitioner recommended by a relative or a subway advertisement, clients could rely on a large retailer's reputation for service that supports all of its profit-making activities, including law practice.

F. BEYOND CLIENTS

The new business structures discussed above have resembled law firms in the sense of delivering legal expertise in the context of client relationships. However, there are several ways that firms might gain from selling legal expertise other than by advising specific clients in specific transactions or litigation. The following are a few examples.

1. Financial analysis

Much of the information that determines securities prices is based on the market's understanding of provisions in contracts such as those relating to the circumstances and consequences of loan default. Financial analysts and investors can hire lawyers to provide this analysis, but may not want to have on board all of the specialists necessary to analyze myriad different deals. Thus there is arguably a demand for a firm like Covenant Review, which "creatively analyzes the indentures, credit agreements, and other contracts that determine creditor rights."¹⁵⁴

2. Litigation financing

Hedge funds investing in litigation are changing the traditional lawyer-client model of litigation.¹⁵⁵ Litigation financing is constrained by a patchwork of laws in some states against a variety of outside funding practices, including maintenance (where a person agrees to support another in bringing or defending a legal action), champerty (maintenance where an investor receives a share of the proceeds of the lawsuit) and barratry (maintenance that promotes groundless judicial proceedings).¹⁵⁶ However, no

¹⁵³ See *supra* section II.E.4.

¹⁵⁴ See "Why Covenant Review," <http://www.covenantreview.com/>.

¹⁵⁵ These include Allianz ProzessFinanz, Harbour Litigation Funding, IM Litigation Funding, and Juridica Capital Management, which has raised over £100 million in two public offerings in 2007 and 2009. Litigation financiers even have a trade association, the American Legal Finance Association (ALFA, <http://www.americanlegalfin.com/>). For a general discussion of litigation financing, see Susan Lorde Martin, *The Litigation Financing Industry: The Wild West of Finance Should Be Tamed Not Outlawed*, 10 Fordham J. Corp. & Fin. L. 55, 55–56 (2004). For a general policy discussion of selling legal claims, see Michael Abramowicz, *On the Alienability of Legal Claims*, 114 Yale L.J. 697 (2005).

¹⁵⁶ See Paul Bond, *Making Champerty Work: An Invitation To State Action*, 150 U. PA. L. REV.

states prohibit outside litigation finance and only two states regulate it, primarily by mandating disclosures.¹⁵⁷

Outside litigation funding has been attacked on the ground that it may increase frivolous litigation.¹⁵⁸ To be sure, there is evidence that permitting litigation financing increases litigation.¹⁵⁹ However, outside financing of litigation may encourage socially valuable suits as well as frivolous claims.¹⁶⁰ Moreover, prohibitions may leave anomalous gaps by permitting funding by insurance companies,¹⁶¹ or by lawyers through contingent fees. Accordingly, the best outcome is regulation rather than prohibition, including by ensuring that litigation financing does not systematically favor plaintiffs over defendants.

Calls to regulate litigation financing are significant for present purposes mainly because they provide hints about public reaction to the new approaches to law practice discussed in this Part. The objections may reflect general unease with moving control over litigation away from lawyers and their professional rules. That would help explain the willingness to tolerate litigation that stays under lawyers' control, such as contingent fees. Similar reasoning applies to many of the other alternatives to Big Law discussed in this Part, including moving law practice in-house, or into Wal-Marts or consulting firms. This connects with the discussion of regulatory impediments to law's new business model discussed in the next Part.

1297 (2002) (including an appendix of state laws); Susan Lorde Martin, *Syndicated Lawsuits: Illegal Champerty or New Business Opportunity?* 30 AM. BUS. L.J. 485 (1992).

¹⁵⁷ See 9-A ME.REV.STAT. ANN. §§ 12-104, 12-106; OHIO REV.CODE ANN. §1349.55. General regulation of litigation also may be applied to outside funders. See *Abu-Ghazaleh v. Chaul*, (Fla. App., December 2, 2009) (enforcing civil theft statute regulating meritless litigation against outside funder who paid litigation costs, received a share of the proceeds, and had veto over whether litigation was filed, who would file it, how it was pursued and settled).

¹⁵⁸ See John Beisner, Jessica Miller and Gary Rubin, *Selling Lawsuits, Buying Trouble: Third-Party Litigation Funding in the United States*, U.S. Chamber Institute for Legal Reform (October, 2009), <http://www.instituteforlegalreform.com/images/stories/documents/pdf/research/thirdparty litigation financing.pdf>.

¹⁵⁹ See David Abrams and Daniel L. Chen, *A Market for Justice: The Effect of Litigation Funding on Legal Outcomes*, <http://home.uchicago.edu/~dlc/papers /MktJustice.pdf> (finding that litigation increased after a favorable ruling on litigation finance in Australia).

¹⁶⁰ See Jonathan T. Molot, *A Market Approach to Litigation Accuracy* (working paper, September, 2009). A public choice argument for regulating litigation financing is that it is politically easier to prevent a new device than to change the current politically entrenched structure for regulating litigation. See Paul H. Rubin, *Third Party Financing of Litigation* (working paper).

¹⁶¹ See David Dana & Max Schanzenbach, *How Would Third Party Financing Change the Face of American Tort Litigation? The Role of Agency Costs in the Attorney-Client Relationship* (Working Paper, September 14, 2009).

3. Legal product design

As discussed above, there are existing and potential products that could commoditize for various types of transactional and litigation work.¹⁶² However, this discussion indicated problems that law firms would have moving beyond representing individual clients and profiting from the design and sale of these products. This presents a potential opportunity for non-law-firm companies, such as software firms, which could use legal expertise in the design of the products.¹⁶³ The problem for those firms, as discussed below,¹⁶⁴ is that lawyer licensing laws create problems bridging what might be termed the “last mile” from general software design to advising clients.

III. THE ROAD TO THE LAW’S NEW BUSINESS MODEL

This article has shown that the traditional reputational bonding model of Big Law always has been precarious, and that recent developments have made it increasingly untenable. It follows that the structure of the legal services industry has to change. Whether and how it changes depends importantly on regulation of the legal profession. This regulation is to a significant extent responsible for the success of Big Law by maintaining lawyers’ privileged status against erosion by market forces. However, the regulation is now preserving what is left of an outmoded business model. This Part discusses the regulatory roadblocks that are preventing alternative models of delivering legal services from taking center stage and the forces that might hurdle them.

A. REGULATORY IMPEDIMENTS TO THE NEW MODEL

Three important general regulatory principles constrain dissemination of legal knowledge. First, regulation of the legal profession long has centered on the relationship between individual lawyers and clients and on ensuring that lawyers will exercise their independent judgment on clients’ behalf. This undercuts duties to firms that are necessary to maintain the viability of large firms. Second, lawyer licensing laws restrict those who are not licensed lawyers from giving legal advice. This ensures that lawyers play a key role in law-related transactional work and litigation and impedes development of legal information products. Third, the law applicable to regulating lawyers is that of the jurisdiction where lawyers practice or render legal advice. This effectively requires the law relating to multistate firms to be uniform across jurisdictions and constrains the evolution of business structures. The following subparts review these regulatory constraints and their impact on the development of alternatives to Big Law.

1. Non-lawyer ownership

Ethical rules restrict ownership of law firms by non-lawyers.¹⁶⁵ This significantly restricts use or conveyance of legal knowledge in any firm lawyers do not own and

¹⁶² See *supra* subpart II.B.

¹⁶³ One example is Dealbuilder, a web-based program for automating contract formation. See *supra* note 107.

¹⁶⁴ See *infra* section III.A.3.

¹⁶⁵ See Model Rules of Professional Conduct Rule 5.4.

control, and therefore the development of multidisciplinary and outside financed firms. This rule helps ensure that the use of legal expertise is constrained by the norms of the legal profession. However, the increased competition discussed in Part I has already threatened these norms. Moreover, profit-maximizing owners who are subject to competition from a variety of mechanisms for delivering legal services have a long-term incentive to maintain their firm's reputation.¹⁶⁶ Indeed, clients might fare better from capitalist-owned than from lawyer-owned firms, since capitalists would be focused on serving client needs rather than in maximizing lawyers' role in providing these services.

Preserving socially valuable professional norms can be accomplished through directly regulating lawyers' conduct instead of trying to alter their incentives by constraining their firms' capital structure. Alternatively, even if some concern about non-lawyer owners is justified, the law could move toward deregulating law firm financing by permitting non-lawyer professionals to co-own law firms.¹⁶⁷ Professionals at least are presumably committed to client and social norms rather than all-out profit-maximization. These forms of regulation could serve as experimental steps toward eventual full-fledged deregulation of non-lawyer ownership of law-related firms.

2. Non-competition agreements

A key challenge facing law firms is giving their members incentives to build the firm's assets rather than just their own clienteles. These incentives exist only if lawyers can count on profiting from their ownership of the firm, which depends significantly on the firm's ability to keep its key business-getters from fleeing. Non-competition agreements can address this problem by penalizing partners who leave and take with them valuable information and client contacts the firm has developed. This helps protect the firm's investments in reputation, proprietary information, training employees, culture, norms, trade secrets, forms and practices that intellectual property law does not reach, thereby encouraging firms to invest in creating this property.¹⁶⁸

Law firms, unlike other types of firms,¹⁶⁹ face ethical restrictions on entering into binding non-competes.¹⁷⁰ The prohibition is intended mostly to ensure the lawyer's

¹⁶⁶ See *supra* text accompanying note 134.

¹⁶⁷ For policy arguments on multi-disciplinary law firms, see John Quinn, *Multidisciplinary Legal Services and Preventive Regulation*, in *Lawyers and the Consumer Interest: Regulating the Market for Legal Services* 329 (Robert G. Evans & Michael J. Trebilcock eds., 1982); John S. Dzienkowski, *Multidisciplinary Practice and the American Legal Profession: A Market Approach to Regulating the Delivery of Legal Services in the Twenty-First Century*, 69 *Fordham L. Rev.* 83 (2000); Daniel R. Fischel, *Multidisciplinary Practice*, 55 *Bus. Law.* 951 (2000).

¹⁶⁸ See Paul H. Rubin & Peter Shedd, *Human Capital and Covenants Not to Compete*, 10 *J. Legal Stud.* 93 (1981); Stewart E. Sterk, *Restraints on Alienation of Human Capital*, 79 *Va. L. Rev.* 383 (1993).

¹⁶⁹ For discussions of enforcement of non-competition agreements, see *Restatement (Second) of Contracts* § 188 (1981); Phillip J. Closius & Henry M. Schaffer, *Involuntary Nonservitude: The Current Judicial Enforcement of Employee Covenants Not to Compete--A Proposal for Reform*, 57 *S. Cal. L. Rev.* 531 (1984).

¹⁷⁰ See Model Rules of Professional Conduct Rule 5.6.

loyalty to individual client interests and protect against an unseemly “barter in clients.”¹⁷¹ The rule embraces not only direct prohibitions on competition, but contractual penalties designed to deter competition by leaving partners, including reductions of post-withdrawal compensation of partners who stay in practice.¹⁷² Although the rule authorizes some kinds of agreements protecting against actual damage from lawyers’ departure,¹⁷³ uncertain enforcement inhibits firms from making large investments in property that may walk away.

Restrictions on law firm non-competes have several potentially perverse effects on law firm structure. First, the agreements inhibit training of young lawyers who might leave with the training and valuable client contacts. This forces firms to rely more heavily on lateral hires. Growth through entry-level hiring can enhance firm stability because the firm can more easily instill a common culture in entry-levels than in more experienced lawyers.

Second, the restriction on non-competes tends to help larger, more sophisticated clients who have significant leverage in dealing with individual lawyers, while hurting the smaller clients who need to rely on firms’ reputational bonds. Lawyers can leave and build an independent practice around their larger clients whenever this suits these clients’ needs. This leaves the smaller clients stuck in the weakened firm and encourages lawyers to cater to their bigger clients.

Third, the prohibition on non-competition agreements inhibits firms from developing new types of legal products that standardize legal services and forces them to rely on individualized client advice. As discussed above, standardized legal advice and law firm research and development may not be protected by trade secret or copyright law and therefore might walk out the door with departing lawyers.¹⁷⁴ Noncompetition agreements fill this legal gap by preventing employees from working in specialties or geographic areas where they could capitalize on information learned from the firm.

Fourth, the prohibition on noncompetes makes it harder for law firms to encourage partners to build the firm’s reputation through monitoring and supervision of other lawyers. This monitoring does not pay off in terms of building lawyers’ individual books of business. As noted above, lawyers’ incentive to work for the firm’s collective

¹⁷¹ The history and rationales of the rule are discussed in Ribstein, *supra* note 4.

¹⁷² See *Weiss v. Carpenter, Bennett & Morrissey*, 672 A.2d 1132 (N.J. 1996) (leaving partner would forfeit part of payout if he were to withdraw from the firm before the age of 65 for any reason other than death, disability, or judicial appointment); *Denburg v. Parker Chapin Flattau & Klimpl*, 624 N.E.2d 995 (N.Y. 1993) (requirement that withdrawing partner pay monetary penalty); *Cohen v. Lord, Day & Lord*, 550 N.E.2d 410 (N.Y. 1989) (agreement denying withdrawing law partner distributions from post-dissolution receipts).

¹⁷³ See *Rutkowski v. Hill, Betts & Nash*, 613 N.Y.S.2d 874 (N.Y. App. Div. 1994) (retirement plan may prohibit retirees from impairing the firm’s relationships with its existing clients); *Howard v. Babcock*, 863 P.2d 150 (Cal. 1993) (agreement may adjust withdrawal compensation to reasonably reflect actual damage to the firm from the withdrawal).

¹⁷⁴ See *supra* subpart II.B.

good depends on whether they can expect their colleagues also to do so, which in turn depends in part on whether enforceable agreements bind lawyers to the firm.

3. Lawyer licensing

Laws penalizing the unauthorized practice of law¹⁷⁵ make the other restrictions discussed in this section binding by forbidding firms that are not subject to the rules from practicing law.

These laws are questionable policy. They assume a need to screen unqualified lawyers in order to prevent the development of a “lemons” market in which consumers do not know whom to trust and therefore distrust lawyers generally.¹⁷⁶ However, licensing laws cannot ensure lawyer competence beyond the minimal level tested a single time by the bar exam.¹⁷⁷ The extra costs of legal representation resulting from forcing lawyers to attend law school and pass a bar exam therefore may not be worth the benefits in terms of protecting clients from shoddy or dishonest work. These policy arguments could fuel constitutional challenges to lawyer licensing by raising questions as to the public interest served by the regulation. The Supreme Court already has applied the First Amendment and the antitrust laws to prevent courts and bar groups from fixing fees or barring solicitation or advertising.¹⁷⁸ Courts also might apply the privileges and immunities and dormant commerce clauses to restrict the effect of state licensing laws on multistate law practice.¹⁷⁹

Forcing consumers of legal advice to hire only those with costly broad-based legal training is particularly questionable where the advice is narrow and routine. Unauthorized practice laws have been applied in these cases without regard to whether non-lawyers can give the same quality service as lawyers, whether clients need legal protection, or whether they could be protected other than by licensing laws.¹⁸⁰ Moreover, consumers of this advice are likely to have the most need for low-cost services, and to avoid any advice at all if the only alternative is to hire a high-priced lawyer. Unsophisticated consumers may be protected more efficiently by regulating specific activities or practices rather than requiring anybody performing broadly defined legal services to obtain a costly license.

¹⁷⁵ For materials on the definition of unauthorized practice, see Center for Professional Responsibility, American Bar Association, Task Force on the Model Definition of the Practice of Law, <http://www.abanet.org/cpr/model-def>. For a general policy analysis of unauthorized practice laws, see Deborah L. Rhode, *Policing the Professional Monopoly: A Constitutional and Empirical Analysis of Unauthorized Practice Prohibitions*, 34 STAN. L. REV. 1 (1981).

¹⁷⁶ See generally, Hayne E. Leland, *Quacks, Lemons, and Licensing: A Theory of Minimum Quality Standards*, 87 J. Pol. Econ. 1328 (1979), Thomas G. Moore, *The Purpose of Licensing*, 4 J.L. & Econ. 93 (1961); Carl Shapiro, *Investment, Moral Hazard, and Occupational Licensing*, 53 Rev. Econ. Stud. 843 (1986).

¹⁷⁷ These arguments are reviewed in Ribstein, *supra* note 61.

¹⁷⁸ See generally, Rhode, *supra* note 175.

¹⁷⁹ See Andrew W. Perlman, *A Bar Against Competition: The Unconstitutionality of Admission Rules for Out-Of-State Lawyers*, 18 GEO. J. LEGAL ETHICS 135 (2004).

¹⁸⁰ See Rhode, *supra* note 175 at 85-86.

More broadly, licensing laws constrain the development of legal information products. Courts generally distinguish self-help books or drafting do-it-yourself legal kits that do not involve individualized advice from legal computer software and Internet services that give advice to individual users.¹⁸¹ For example, a firm can sell will-making software that provides general guidance, but may not make a program that is sophisticated enough to give individualized advice on particular issues.¹⁸² Firms can develop deal-making software, but licensing laws may constrain them from developing products that automate formation of specific contracts without the assistance of a lawyer. Licensing laws therefore protect the current model of legal advice from competition with other models of legal advice or provision of legal information. Without this regulation, firms would have incentives to invest in, for example, software and data that could automate contract drafting or aspects of litigation, or guide businesses on likely legal outcomes of particular decisions or contract provisions.¹⁸³

4. Choice of law

The current regulatory system subjects individual lawyers to ethical rules of the states where they are based, and so subjects the structure of national law firms to the laws of all the states in which they have offices.¹⁸⁴ If law firms cannot choose their regulating state, as standard business corporations generally do by deciding where to incorporate, they need uniform rules, which decrease regulatory flexibility and experimentation¹⁸⁵ and are susceptible to interest group manipulation.¹⁸⁶

It follows that regulation of law firm structure needs to be subject to the same choice of law rule as other business association governance – that is, the internal affairs doctrine.¹⁸⁷ Applying the internal affairs doctrine to regulation of law firm structure

¹⁸¹ See Ribstein, *supra* note 61 at 357-62.

¹⁸² See Hadfield, *supra* note 144.

¹⁸³ *Id.*

¹⁸⁴ See Model Rules of Professional Conduct, Rule 8.5 (providing for application of rules of the jurisdiction in which the court sits for conduct in a judicial proceeding, local rules if the lawyer is licensed locally, or the rule where the lawyer principally practices unless the lawyer's conduct has its predominant effect in another jurisdiction where the lawyer is licensed). These constraints on law firm structure do not apply to conventional business firms as long as they are not deemed to be engaged in law practice. As law distinctions between law and non-law firms blur along the lines discussed in Part II, questions may arise as to which types of firms are subject to these restrictions. This might, in turn, add to the competitive pressure on existing regulation discussed below.

¹⁸⁵ See Committee on Counsel Responsibility, *Risks of Violation of Rules of Professional Responsibility by Reason of the Increased Disparity Among the States*, 45 Bus. Law. 1229, 1235-37 (1990); Duncan T. O'Brien, *Multistate Practice and Conflicting Ethical Obligations*, 16 Seton Hall L. Rev. 678, 720-21 (1986); Jeffrey L. Rensberger, *Jurisdiction, Choice of Law, and the Multistate Attorney*, 36 S. Tex. L. Rev. 799, 813-14 (1995); *Developments in the Law--Lawyers' Responsibilities and Lawyers' Responses*, 107 HARV. L. REV. 1547, 1583-86 (1994).

¹⁸⁶ See Bruce H. Kobayashi & Larry E. Ribstein, *Economic Analysis of Uniform State Laws*, 25 J. LEG. STUD. 131, 140-43 (1996).

¹⁸⁷ See Larry E. Ribstein, *Ethical Rules, Law Firm Structure and Choice of Law*, 69 U. CIN. L.

could create regulatory competition that would loosen the bar's political control over lawyer regulation and create an opportunity to develop rules that better serve the interests of clients and other third parties. Firms' ability to choose the state law that governs their structure also would encourage experimentation and the development of alternative models for regulating dissemination of legal knowledge.

The application of the internal affairs doctrine is important in facilitating the development of new business structures suited for the new type of law firm discussed in this article. Crafting these forms is challenging because of the need for coherent statutes that suit different types of firms.¹⁸⁸ Because no single group of legislators or private parties has all of the necessary information, these statutes need to evolve over time.¹⁸⁹ This is particularly true for legal services firms, which are searching for a viable business model. Multiple statutes may have to develop for different types and sizes of law firms. States may specialize in legislating for different types of firms, just as Delaware has tailored its business association statutes to cater to the corporate law needs of large corporations. The recent experience with the evolution of limited liability company statutes demonstrates states' ingenuity in crafting new business forms.¹⁹⁰ This development has been led by lawyers,¹⁹¹ who are even more likely to lead the development of statutes for law firms, in which they have particular interest and expertise.

Some may argue that applying the internal affairs doctrine to law firm structure will lead to a "race to the bottom" in which lawyers draft the statutes and seek the states with the lightest regulation. This would seem particularly to be a problem because of lawyers' information advantages over clients and the need to protect against lawyer-client agency costs. Moreover, these statutes may affect broader social interests that are not represented either in statutory drafting or in bargaining with lawyers or law firms. However, it is important to keep in mind that the statutes would be mainly designed for governing the relationship among lawyers in the firm. Specific regulations could still protect clients and society from lawyers' misconduct.

B. OVERCOMING THE IMPEDIMENTS

The regulation that is impeding a shift to a new business model is not an implacable barrier. Potential profits from eliminating the restrictions give lawyers and

REV. 1161 (2001). For a more general analysis of the internal affairs doctrine, see Larry E. Ribstein & Erin A. O'Hara, *Corporations and the Market for Law*, 2008 ILL. L. REV. 661.

¹⁸⁸ For discussions of the coherent design of business association statutes, see Ribstein, *supra* note 36, Chapter 2; Larry E. Ribstein, *Statutory Forms for Closely Held Firms: Theories and Evidence from LLCs*, 73 Wash. U. L.Q. 369 (1995).

¹⁸⁹ See Bruce H. Kobayashi & Larry E. Ribstein, *Evolution and Spontaneous Uniformity: Evidence from the Evolution of the Limited Liability Company*, 34 ECON. INQUIRY 464 (1996).

¹⁹⁰ See Bruce H. Kobayashi and Larry E. Ribstein, *Jurisdictional Competition for Limited Liability Companies* (July 9, 2009), U Illinois Law & Economics Research Paper No. LE09-017, <http://ssrn.com/abstract=1431989>.

¹⁹¹ See Ribstein, *supra* note 61.

clients a strong incentive to surmount the barriers. This subpart discusses some possible scenarios for change.

1. Competition

Ethical rules are unstable to the extent that they pit the legal profession's collective interest against individual lawyers' self-interest. Those who incur the highest costs from these rules will take the lead in changing them. Change is particularly likely to come from smaller firms operating on the edges of conventional professional norms that seek to offer lower cost services without costly large firm baggage.¹⁹²

Legal ethical rules also face pressure from outside the profession. If freed from ethical and licensing rules, non-lawyers could perform legal-type services. They have a strong interest in competing for the profits from rendering legal services, particularly as law's domain expands through regulation. Non-lawyer competitors could erode licensing restrictions through creative contracting and litigation. Non-lawyer professionals such as accountants also have an incentive to erode lawyers' privileged access to advising on lucrative transactions.

There is also growing international regulatory competition, particularly between the US and UK.¹⁹³ Before 1986, the UK did not let US law firms give advice on US law in London. This regulation was relaxed as part of the UK's 1986 "Big Bang" financial regulation, which exposed UK firm to more performance-based US-style compensation structures and encouraged mergers of US and UK firms, including Clifford Chance and Rogers & Wells. The UK then took deregulation further than the US in passing the Legal Services Act (2007), which permitted firms to attract non-lawyer investors.¹⁹⁴ Meanwhile, similar deregulation in the Australian state of New South Wales has led to the first law firm public offering.¹⁹⁵ Liberated Australian and possibly UK firms ultimately may compete directly with US firms that are subject to more stringent ethical constraints. If US regulators try to block this competition, they may face pushback not only from clients interested in cheaper and more efficient legal services, but also from trade regulators.¹⁹⁶

¹⁹² See Henderson & Bierman, *supra* note 17; Eli Wald, *The Rise and Fall of the WASP and Jewish Law Firms*, 60 STAN. L. REV. 1803 (2008) (discussing the rise of the elite Jewish law firms through takeover work shunned by Wall Street firms).

¹⁹³ See James Faulconbridge and Daniel Muzio, *The Financialization of Large Law Firms: Situated Discourses and Practices of Reorganization*, 9 J. ECON. GEOGRAPHY 641 (2009) (summarizing this history).

¹⁹⁴ See *supra* note 131 and accompanying text.

¹⁹⁵ See *supra* text accompanying notes 129-130.

¹⁹⁶ See Laurel S. Terry, *GATS' Applicability to Transnational Lawyering and its Potential Impact on U.S. State Regulation of Lawyers*, 34 VAND. J. TRANSNATL. L. 989 (2001).

2. Contracts

Clients seeking lower-cost legal services may want to waive ethical constraints on competition among law firms. Courts may enforce these waivers, at least by large and sophisticated corporate clients. Lawyers might avoid a particular jurisdiction's ethical rules by contracting with their clients concerning which state's ethical regime applies. Clients may consent to law firms' limited liability through the firm's disclosure of its limited liability form,¹⁹⁷ and to the firm's jurisdictional choice regarding conflicts of interest.¹⁹⁸ Lawyers also may negotiate for arbitration clauses in their law firm partnership agreements, which might get them a more sympathetic hearing on enforcement of noncompetition clauses than they would get in court.¹⁹⁹ Firms and clients can avoid jurisdictions that do not enforce these contracts, thereby pressuring those jurisdictions to enforce such contracts.²⁰⁰

3. Regulatory arbitrage

Law firms might escape restrictions on non-lawyer ownership through financial instruments and contracts that exploit the nearly infinite potential variations on the concept of ownership. It is arguably only a small step from litigation financing arrangements to outside financing of entire litigation firms. Also, several recent cases have considered whether management services contracts between management companies and medical partnerships involving extensive administrative and support services and profit sharing were illegal partnerships.²⁰¹ Given sufficient demand for these arrangements, firms could keep tweaking the terms until they find a reliable loophole.

Perhaps most importantly, law firms might skirt the prohibition on outside financing through financial derivatives that pay off depending on the firm's capitalized earnings.²⁰² As long as the holders of these instruments are not characterized as owners of the law firm, they would no more violate Model Rule 5.4(a) than would the banks

¹⁹⁷ See ABA Comm. on Ethics and Professional Responsibility, Formal Op. 96-401 (Aug. 2, 1996) (stating that use of the statutorily required abbreviation in public communications is sufficient to make such communications not misleading or deceptive under Model Rules 7.1 and 7.5(a), and that an LLP referring to itself as a "partnership" is not an actual or implied misrepresentation).

¹⁹⁸ See Task Force on Conflicts of Interest, ABA, Conflicts of Interest Issues, 50 BUS. LAW. 1381, 1426 (1995) (suggesting that firms include choice-of-law clauses in engagement letters to deal with client conflict issues).

¹⁹⁹ With respect to the relationship of arbitration clauses and choice of law, see Erin A. O'Hara & Larry E. Ribstein, *THE LAW MARKET*, Ch. 5 (2009).

²⁰⁰ See *id.* Chapter 4 (discussion role of party mobility in securing enforcement of choice of law clauses).

²⁰¹ For cases holding that the relationships were partnerships, see *In re OCA, Inc.*, 552 F.3d 413 (5th Cir. 2008); *Warren J. Apollon, D.M.D., P.C. v. OCA, Inc.*, 2008 WL 5427701 (E.D. La. Dec. 30, 2008); *OCA, Inc. v. Hodges*, 615 F.Supp.2d 477 (E.D.La., 2009) (Pa. law). For a case contra see *In re OCA, Inc.*, 378 B.R. 493 (Bankr. E.D. La. 2007).

²⁰² See MacEwen, et al, *supra* note 129.

loaning money to law firms. Whether they are considered owners might depend on state partnership law, as with the management service contracts noted above. Under this law, even if the derivative-owners are deemed to be profit-sharers, they may nevertheless not be partners if they lack control over the business and are clearly characterized as non-partners in the relevant agreements.²⁰³ Conversely, some partnership statutes allow firms to admit partners without economic interests.²⁰⁴ If the economic nature of the interest is not controlling, characterization might turn on such ephemeral elements as the degree of control or how the parties characterize the arrangement in their agreement. The concept of ownership provides ample opportunities for envelope-pushing given an underlying demand for outside financing combined with pressure from clients and international competition discussed in the preceding sections,

IV. IMPLICATIONS AND CONCLUSIONS

In sum, Big Law is threatened by its inherent instability as well as client demands for cheaper and more sophisticated legal products, competition among various providers of legal services, and national and international regulatory competition. The death of Big Law will open the door to new methods of disseminating legal knowledge and threaten the regulatory barriers that have sustained the autonomy of the legal profession. This Part briefly considers some implications of these developments for legal education, the creation of law and the role and function of lawyers.

A. LEGAL EDUCATION

The most immediate effect of the death of Big Law is that legal education will have to change in several important ways. First, a major shift in market demand for law graduates must affect the demand for and price of legal education. Big Law's inverted pyramid, by which law firms can bill out even entry-level associate time at high hourly rates, has created a high demand and escalating pay for top law students. The pressures on Big Law discussed throughout this article are ending this era with layoffs, deferrals, pay-reductions and merit-based pay. Although law school applications appear to be holding up through the end of 2009, as the recession still affects overall employment, this may not continue if the general economy improves but the demand for Big Law does not. Law schools will have to find education models that are more cost-effective and that address employer demands in the new market for law graduates discussed in this Part.

Second, law schools will have to undertake much of the training that they traditionally have delegated to Big Law and other employers. Because client pressure is likely to push fees to better reflect associates' level of training and experience, law firms will have to internalize all training costs. The increasing instability of large law firms and their lack of any device, such as non-competition agreements, for binding trained lawyers to the firm make it unlikely this investment will pay off. Moreover, the decline of the tournament model of Big Law hiring means that law graduates no longer can expect to benefit from the multi-year training and screening period the tournament used to offer.

²⁰³ See Bromberg & Ribstein, *supra* note 40, §2.07(b)(3).

²⁰⁴ See 6 DEL. CODE §15-205 (general partnership); *id.* §17-301(d) (limited partnership); *id.* §18-301(d) (LLC); Ribstein, *Rise*, *supra* note 36, §7.C.1.

Third, law schools face uncertainty as to what they should train their students to do. The development of legal products and the increasing use of technology in law practice require technical training that enables lawyers to do more than just litigate and give individualized advice.²⁰⁵ The use of law in finance, the increasing importance of in-house counsel and the combination of law with other types of expertise, among other developments, require lawyers who can function within business rather than just delivering technical legal advice from the outside. Law school may need to offer more business background in both advanced seminars and basic courses like business associations, securities regulation, antitrust and bankruptcy. Law firm research and development and the rise of multidisciplinary firms also could increase the need for law graduates who can work in, or at least with, multiple disciplines, including accounting, finance, psychology, and economics.

Fourth, it is not clear that law schools themselves should offer all this training. As law practice becomes increasingly integrated with business and with other disciplines, students increasingly may enter law school with advanced training in other specialties, and PhD, MBA, MD or other advanced degrees. They may use law school mainly to become proficient in using the legal system.

B. LAW CREATION

The decline of law schools and large law firms is part of broader inroads on lawyers' virtually monopoly over law creation. Lawyer licensing has entrenched lawyers' and law firms' leadership in law creation by giving lawyers a kind of property right in law.²⁰⁶ The breakdown of licensing and ethical restrictions and the rise of new models for the law business may make law more literally a product. Law's new producers may be, for example, the multi-disciplinary consulting or investment firms that may be replacing Big Law.

C. THE END OF "LAWYERS"

The potentially dramatic expansion of law-disseminators may reduce the role of specially trained and credentialed "lawyers" as official intermediaries in the regulatory process. Lawyers' current role as official purveyors of legal knowledge lets them act as "passkeys" to important legal events, from corporate mergers to litigation. This monopoly power is not necessarily desirable.²⁰⁷ Opening up the field of law dissemination could have profound implications for how society is regulated and the nature of that regulation. Lawyers are currently a powerful interest group, well organized through bar associations, and motivated to enact and maintain laws whose administration

²⁰⁵ See Cunningham, *supra* note 107 at 363-64 (discussing new training required to prepare lawyers to use XML in contract creation).

²⁰⁶ See Ribstein, *supra* note 61 (showing how lawyers can capture the benefits of legal innovation in the jurisdictions in which they are licensed because their licenses give them exclusive access to clients and courts in those jurisdictions).

²⁰⁷ See Hadfield, *supra* note 144 (discussing the social costs of non-competitive markets for legal services).

enriches the legal profession. Broadening the class of those who can give legal advice accordingly might reduce, or at least reconfigure, the demand for regulation.